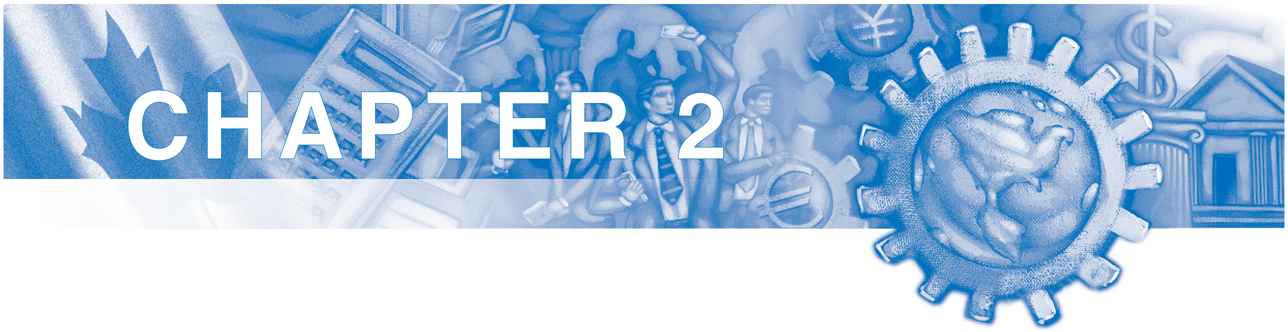
Detailed Contents Of Chapter 2

Investments In Equity Securities

(continued)



Investments In Equity Securities

Introduction

Objectives

2-1. This Chapter has three objectives. Stated briefly, these are:

> **Classification** To provide you with an understanding of the classification of various types of investments in equity securities under the recommendations of the *CICA Handbook*. This is of particular importance in that an investment's classification determines the accounting procedures that will be applied.
>
> **Accounting Methods** To provide you with the ability to apply some of the accounting methods that will be used to account for investments in equity securities.
>
> **Matching Of Classifications And Methods** To provide you with the ability to select the appropriate accounting method to be applied to each of the identified classifications of investments in equity securities.

2-2. This effort is complicated by the fact that investments in equity securities are dealt with in several different Sections of the *CICA Handbook*. These are:

- Section 1590, "Subsidiaries", provides guidance on the required accounting treatment for subsidiaries.
- Section 1600, "Consolidated Financial Statements", provides guidance on specific consolidation procedures.
- Section 3051, "Investments", provides guidance on the identification of, and the accounting procedures to be used for, significantly influenced investments.
- Section 3055, "Interests In Joint Ventures", provides guidance on the identification of, and the accounting procedures to be used for, joint ventures.
- Section 3855, "Financial Instruments - Recognition And Measurement", provides guidance on the identification of, and the accounting procedures to be used for, held-for-trading and available-for-sale investments.

Classification

2-3. Our introductory Chapter provided a brief discussion of the various types of investments in equity securities that are identified in the *CICA Handbook*. These are:

Non-Strategic Investments
- Held-For-Trading Investments
- Available-For-Sale Investments

Strategic Investments
- Subsidiaries
- Significantly Influenced Companies
- Joint Ventures

2-4. In this Chapter, we will provide a detailed discussion of how each of these classifications is defined, including any conceptual problems that may be associated with the process of identifying investments in each category.

2-5. There is an additional type of investment that we have not included in this list. As some of you may be aware, there are now *CICA Handbook* requirements for the consolidation of what is referred to as a "variable interest entity". Identification of variable interest entities is a very complex process and, in many cases, does not involve holdings of equity securities. For these reasons, we have excluded it from our basic list of investment classifications. However, some discussion of these arrangements will be included with our coverage of subsidiaries.

Accounting Methods

2-6. Depending on the classification of the investment in equity securities, a variety of accounting methods may be used. The ones that are identified in the *CICA Handbook* are as follows:

- cost method
- equity method
- fair value method (with changes in Net Income)
- fair value method (with changes in Comprehensive Income)
- full consolidation
- proportionate consolidation

2-7. This Chapter will provide coverage of all of these methods other than full and proportionate consolidation. Full consolidation procedures are the subject of Chapters 4 through 7 of the text. Proportionate consolidation is dealt with in Chapter 8.

2-8. This Chapter's coverage of the cost method and the two fair value methods will be complete, with no further attention to these methods in subsequent Chapters. With respect to the equity method, basic procedures will be introduced in this Chapter. However, the full application of the equity method requires a complete understanding of the consolidation procedures that will be covered in later Chapters. Given this, we will return to the application of the equity method in both Chapter 5 and Chapter 6.

Organization

2-9. After a section dealing with the conceptual basis for classification of investments in equity securities, the basic material in this Chapter will be organized in terms of investment classifications. A major section will be devoted to each category of investments in equity securities. Each of these sections will include:

- a definition of the investment classification; and
- an indication of the accounting method that must be used for that classification.

2-10. Also included in some of these sections will be detailed coverage of the procedures related to the required accounting method. However, as indicated in Paragraphs 2-7 and 2-8, detailed coverage of full and proportionate consolidation procedures will be presented in later chapters. In addition, coverage of some aspects of the equity method will be deferred to

Chapters 5 and 6.

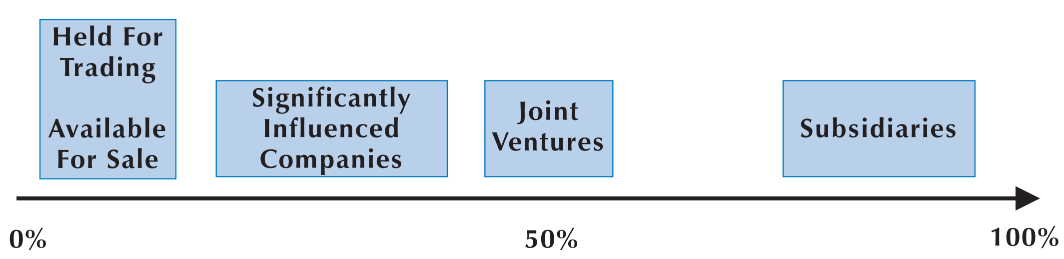
2-11. At the end of these sections, a summary table of the classifications and their appropriate accounting methods will be presented.

2-12. Additional sections will follow, providing coverage of other issues associated with investments in equity securities. This will include write-downs for impairment, gains and losses on the sale of investments, differential reporting options, disclosure, and the application of international standards to investments in equity securities.

The Conceptual Basis For Classification

2-13. The classification of investments in equity securities is largely related to the ability of the investor company to influence the affairs of the investee. In most cases, that influence is in proportion the percentage of voting shares held. This basic approach to classification is illustrated in Figure 2-1.

Figure 2-1
Spectrum Of Influence Based On Voting Share Ownership



2-14. As shown in Figure 2-1, the investment classification involving the highest degree of influence is subsidiaries. In general, this type of investment involves situations where the investor company owns more than 50 percent of the outstanding voting shares of the investee company. However, as will be discussed in our more detailed discussion of this classification, such majority ownership is not a required part of the definition of a subsidiary.

2-15. At the other extreme we find the investment classifications of held-for-trading and available-for-sale. These are investment situations in which the investor company has little or no influence over the affairs of the investee company and, as can be seen in Figure 2-1, this situation normally involves relatively small holdings of investee voting shares.

2-16. The basic idea with investments in significantly influenced companies is that the investor company has the ability to influence the operating, financing, and investing decisions of the investee, but does not have control over these matters. This would generally require a substantial holding of investee voting shares (the *Handbook* suggests more than 20 percent), but less than the 50 percent plus one share that would give the investor company majority control over the investee.

2-17. Joint ventures involve situations where two or more investors share control of the investee. In Figure 2-1, we have shown this as a 50 percent holding, suggesting that joint control is established through the fact that two investors each own 50 percent of the voting shares of the investee. There are, of course, other possibilities. For example, joint control could be established by an agreement that overrides voting share ownership.

2-18. This overview provides a generalized picture of the investment classifications for equity securities that are found in the recommendations of the *CICA Handbook*. With this in hand, we can now turn to a more detailed consideration of the individual categories.

Held-For-Trading Investments

Definition

Handbook Location

2-19. Investments in equity securities are financial assets and, as such, they are generally subject to the rules in Section 3855 of the *CICA Handbook*, "Financial Instruments - Recognition And Measurement". However, strategic investments in subsidiaries, significantly influenced companies, and joint ventures are excluded from the scope of Section 3855 as they are covered by other specific *Handbook* provisions.

2-20. This is not the case with held-for-trading and available-for-sale investments. These investments are subject to the recognition and measurement rules that are specified in Section 3855. Note, however, the rules for these investments are part of more general recommendations which cover all financial assets and liabilities that are held for trading or available for sale.

General Definition

2-21. Section 3855's general definition of held for trading is as follows:

> **Paragraph 3855.19(f)** A **Financial Asset** or **Financial Liability** held for trading is a financial asset or financial liability that meets either of the following conditions:
>
> (i) it is not a loan or receivable, as defined in paragraph 3855.19(h), and is:
> - acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
> - part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking; or
> - a derivative, except for a derivative that is a designated and effective hedging instrument (see Section 3865, "Hedges"); or
>
> (ii) it is designated by the entity upon initial recognition as held for trading. Any financial instrument within the scope of this Section may be designated when initially recognized as held for trading, except for:
> - financial instruments whose fair value cannot be reliably measured; and
> - financial instruments transferred in a related party transaction that were not classified as held for trading before the transaction.

2-22. It is fairly obvious from a quick reading of this definition, that the term "held for trading" is not appropriate. While the first two bullets under Paragraph 3855.19(f)(i) describe assets that fit the description "held for trading", the remainder of the definition includes two other types of items:

> **Derivatives** Except for derivatives associated with hedging relationships, all derivatives must be classified as held for trading, even in cases where there is no trading activity.
>
> **Designated Items** Paragraph 3855.19(f)(ii) allows any financial asset or financial liability to be designated as held for trading, without regard to an intent to trade or any actual trading activity. Note that, if this designation is made at the initial recognition of the financial asset or financial liability, it cannot be changed at a later date.

Application To Investments In Equity Securities

2-23. Applying this definition to investments in equity securities, we find that two types of items must be classified as held-for-trading investments:

> **Required Items** Equity securities that are held with the objective of generating a profit from short-term fluctuations in price. Management has no discretion in this classification matter.
>
> **Designated Items** Other, non-strategic investments in equity securities that

management has designated as held for trading.

2-24. It is not clear how this designation option will be implemented in practice. Through the use of the designation procedure, a corporation could have all of its non-strategic investments in equity securities classified as held for trading. This would result in a single method of accounting being applied to all of these investments, an advantage that may encourage the use of the designation procedure.

2-25. As we shall see when we look at applicable accounting methods, the disadvantage of designating investments as held for trading is that it will increase the volatility of the Net Income figure. Both held-for-trading and available-for-sale investments must be carried at fair value. The difference is that changes in the fair value of held-for-trading investments must be included in Net Income. On available-for-sale investments, the changes in fair value are included in Comprehensive Income, rather than in Net Income

Required Accounting Procedures

Initial Recognition

2-26. The relevant recommendation here is as follows:

> **Paragraph 3855.55** *When a financial asset or financial liability is recognized initially, an entity should measure it at its fair value*. (October, 2006)

2-27. Application of this in equity investment situations will be a fairly simple matter. Fair value will simply be the amount paid for the equity securities.

2-28. There is, however, one unusual requirement in Section 3855:

> **Paragraph 3855.56** *For a financial asset or financial liability classified as held for trading, all transaction costs should be recognized immediately in net income.* (October, 2006).

2-29. This is in contrast to most other asset acquisition procedures where transaction costs are included in the cost of the asset.

Subsequent Measurement

2-30. Paragraph 3855.66 requires that investments that are held for trading continue to be measured at fair value subsequent to their initial recognition. This will require that at each Balance Sheet date, such investments will be written up or written down to reflect their fair value on that date. This raises the question of how to deal with these changes in value in a complete set of financial statements

2-31. With respect to held-for-trading investments, Paragraph 3855.76 requires that changes in fair value be included in Net Income in the period in which they occur. As will be discussed later in this Chapter, this is in contrast to the treatment of available-for-sale investments where the changes in fair value are allocated to Comprehensive Income until such time as there is a disposition of the investment.

Fair Value Method With Changes In Net Income

2-32. There is no short-form name for the accounting method that is used for held-for-trading investments. Given this, we will use the somewhat awkward designation “fair value method with change in Net Income”.

2-33. A simple example will serve to illustrate these procedures:

> **Example** Barkin Ltd. is a Canadian public company with a December 31 year end. On January 1, 2007, the company acquires 2,000 shares of Valor Inc. at a cost of $125 per share. Transaction costs total $2,500. The investment does not give Barkin influence over, or control of, Valor Inc. Barkin classifies these shares as held for trading.
>
> On December 31, 2007, the fair value of the Valor shares has increased to $135 per share. The Valor Inc. shares did not declare or pay any dividends during 2007.

On March 1, 2008, Barkin sells all of the Valor shares for $132 per share. Transaction costs for the disposal are $2,600.

2-34. The journal entries required to record these transactions would be as follows:

January 1, 2007		
Investments [(2,000)($125)]	$250,000	
Miscellaneous Expense	2,500	
Cash [(2,000)($125) + $2,500]		$252,500
December 31, 2007		
Investments [(2,000)($135 - $125)]	$20,000	
Gain (Net Income)		$20,000
March 1, 2008		
Cash [(2,000)($132) - $2,600]	$261,400	
Loss (Net Income) [(2,000)($135 - $132)]	6,000	
Miscellaneous Expense	2,600	
Investments ($250,000 + $20,000)		$270,000

Exercise Two-1

Subject: Held-For-Trading Investments

Porter Inc. is a Canadian public company with a December 31 year end. On January 1, 2007, the company acquires 5,000 shares of Santin Ltd. at a cost of $23 per share. Transaction costs total $1,150. The investment does not give Porter influence over, or control of, Santin. Porter classifies these shares as held for trading.

During the year ending December 31, 2007, Santin Ltd. declares and pays dividends of $0.90 per share. On December 31, 2007, the fair value of the Santin shares has declined to $19 per share.

On March 1, 2008, Porter sells all of the Santin shares for $25 per share. Transaction costs for the disposal are $1,250.

Provide the journal entries to record the preceding information on the books of Porter Inc. and a summary of the effect of the investment in Santin on Porter's Net Income.

End of Exercise. Solution available in Study Guide.

Available-For-Sale Investments

Definition

General Definition

2-35. This category of financial instruments is defined in Section 3855 as follows:

> **Paragraph 3855.19(i) Available-for-sale financial assets** are those non-derivative financial assets that are designated as available for sale, or that are not classified as loans and receivables, held-to-maturity investments, or held for trading.

2-36. This is a default or residual classification for financial assets. It contains those financial instruments that have not been included in one of the other three classifications — loans and receivables, held for trading, or held to maturity. Note that held-to-maturity investments would not be investments in equity securities as equity securities have no maturity date.

Application To Investments In Equity Securities

2-37. Given the scope of Section 3855, the general definition of available-for-sale investments in equity securities is that it includes all holdings of equity securities other than:

- investments in subsidiaries;
- investments in significantly influenced companies;
- investments in joint ventures;
- investments that are, in fact, held for trading; and
- investments that have been designated as held for trading.

2-38. As we have indicated previously, use of the designation procedure may result in an enterprise having no investments that are classified as available for sale.

Required Accounting Procedures

Initial Recognition

2-39. As was the case with held-for-trading investments, Paragraph 3855.55 requires that initial recognition of an investment classified as available for sale should be at fair value. However, in this case the *Handbook* allows management to choose between alternative approaches to recording transaction costs:

> **Paragraph 3855.57** *For a financial asset or financial liability classified other than as held for trading, an entity should adopt an accounting policy of either:*
>
> *(a) recognizing all transaction costs in net income; or*
> *(b) adding transaction costs that are directly attributable to the acquisition or issue of a financial asset or financial liability to the amount determined in accordance with paragraph 3855.55.* [**Byrd/Chen Note** See our Paragraph 2-26.] (October, 2006)

Subsequent Measurement

2-40. The procedures to be used subsequent to acquisition will depend on whether the shares of the investee have a quoted market price in an active market. In those cases where such values are available, the procedures for available-for-sale investments are as follows:

- At each Balance Sheet date after initial recognition, the investment will be revised to reflect its fair value as of that date.
- The periodic changes in fair value will be recognized as items of Other Comprehensive Income and included in the Statement Of Comprehensive Income.
- Dividends and interest on financial investments that have been classified as available for sale must be included in Net Income.
- When there is a disposition of an available-for-sale investment in equity securities, any balance of Accumulated Other Comprehensive Income that is related to that investment will be recognized in Net Income.

CD-ROM Note If you are not familiar with Comprehensive Income, or wish to review the subject, it is covered in Chapter 11 of our *Guide To Canadian Financial Reporting* which is found on the CD-ROM that accompanies your text.

2-41. If the shares of the available-for-sale investee do not have a quoted market price in an active market, Section 3855 indicates that the investment should be accounted for using the cost method.

2-42. Both the fair value method with changes in Comprehensive Income and the cost method will be illustrated in the sections which follow.

Fair Value Method With Changes In Comprehensive Income

2-43. A simple example will serve to illustrate the procedures that will be used for available-for-sale investments in cases where market values are available. With appropriate modifications, we will use the same basic example here that we used to illustrate the procedures used on held-for-trading investments in Paragraph 2-33.

Example Barkin Ltd. is a Canadian public company with a December 31 year end. On January 1, 2007, the company acquires 2,000 shares of Valor Inc. at a cost of $125 per share. Transaction costs total $2,500. The investment does not give Barkin influence over, or control of, Valor Inc. Barkin classifies these share as available-for-sale and chooses the option of charging the transaction costs to expense.

On December 31, 2007, the fair value of the Valor shares has increased to $135 per share. The Valor Inc. shares did not declare or pay any dividends during 2007.

On March 1, 2008, Barkin sells all of the Valor shares for $132 per share. Transaction costs for the disposal are $2,600.

2-44. The journal entries required to record these transactions would be as follows:

January 1, 2007

Investments [(2,000)($125)]	$250,000	
Miscellaneous Expense	2,500	
Cash [(2,000)($125) + $2,500]		$252,500

December 31, 2007

Investments [(2,000)($135 - $125)]	$20,000	
Other Comprehensive Income - Gain*		$20,000

*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

Other Comprehensive Income - Loss [(2,000)($132 - $135)]	$6,000	
Investments		$6,000

Cash [(2,000)($132) - $2,600]	$261,400	
Miscellaneous Expense	2,600	
Other Comprehensive Income - Reclassification Adjustment	14,000	
Investments ($250,000 + $20,000 - $6,000)		$264,000
Gain (Net Income) [(2,000)($132 - $125)]		14,000

(When the two Other Comprehensive Income items are closed, the balance in Accumulated Other Comprehensive Income will be reduced to nil ($20,000 - $6,000 - $14,000). The sale entry also recognizes the fact that, during the period that it was held, there was a net gain on the investment of $14,000 ($20,000 in 2007- $6,000 in 2008).)

Exercise Two-2

Subject: Available-For-Sale Investments With Known Market Value

Porter Inc. is a Canadian public company with a December 31 year end. On January 1, 2007, the company acquires 5,000 shares of Santin Ltd. at a cost of $23 per share. Transaction costs total $1,150 and Porter chooses to include them in the cost of the investment. The investment does not give Porter influence over, or control of, Santin. Porter classifies these shares as available for sale.

During the year ending December 31, 2007, Santin Ltd. declares and pays dividends of $0.90 per share. The Santin shares have a quoted market price that is established in an active market. On December 31, 2007, the fair value of the Santin shares has declined to $19 per share.

On March 1, 2008, Porter sells all of the Santin shares for $25 per share. Transaction costs for the disposal are $1,250.

Provide the journal entries to record the preceding information on the books of Porter Inc. and a summary of the effect of the investment in Santin on Porter's Net Income.

End of Exercise. Solution available in Study Guide.

Cost Method

Applicability

2-45. The general rule for available-for-sale investments in equity securities is that they are carried at fair value, with changes in value allocated to Comprehensive Income, rather than to Net Income.

2-46. An exception occurs when the shares of the investee do not have quoted market prices that are established in an active market. In this situation, Paragraph 3855.66(c) indicates that they should be carried at cost.

2-47. While Section 3855 does not use this term, this means that these investments will be accounted for using the cost method. This is the only situation in which this method is applied to investments in equity securities. It can, however, be applied to other types of investments such as real estate and investments in debt securities (for debt securities, the method is referred to as the amortized cost method, reflecting the fact that these securities are often acquired at a premium or a discount).

General Procedures

2-48. The cost method of accounting for investments is a specific application of the general procedures used in accounting for most non-current assets. It is based on the historical cost principle and the fact that an equity investor company's only legal claim to income is based on the amount of dividends declared by the investee company. The *Handbook* defines the method as follows:

> **Paragraph 3051.03(b)** The **cost method** is a basis of accounting for investments whereby the investment is initially recorded at cost; earnings from such investments are recognized only to the extent received or receivable.

2-49. As stated in the preceding Paragraph, the cost method records the investment at its cost and, in most circumstances, the investor company will continue to carry the asset at this value until it is disposed of. In general, the investor will recognize income only when the investee declares dividends ("extent received or receivable"). No recognition is given to changes in the fair value of the investee.

Exercise Two-3

Subject: Available-For-Sale Investments Without Known Market Value

Porter Inc. is a Canadian public company with a December 31 year end. On January 1, 2007, the company acquires 5,000 shares of Santin Ltd. at a cost of $23 per share. Transaction costs total $1,150 and Porter chooses to include them in the cost of the investment. The investment does not give Porter influence over, or control of, Santin. Porter classifies these shares as available for sale.

During the year ending December 31, 2007, Santin Ltd. declares and pays dividends of $0.90 per share.

On March 1, 2008, Porter sells all of the Santin shares for $25 per share. Transaction costs for the disposal are $1,250.

Provide the journal entries to record the preceding information on the books of Porter Inc. and a summary of the effect of the investment in Santin on Porter's Net Income.

End of Exercise. Solution available in Study Guide.

Return Of Capital

2-50. In general, under the cost method, the value recorded for the investment when it is acquired is not altered as long as the investor continues to hold the investment. However, there are situations in which the investee pays dividends in excess of its earnings subsequent to its acquisition by the investor. Such dividends are being paid out of investee Retained Earnings that were present at the time of the investment's acquisition. As the amount paid by the investor reflects this acquisition date balance, such dividends are a return of capital.

2-51. While the *Handbook* no longer discusses this possibility, IAS No. 27, *Consolidated And Separate Financial Statements*, provides a definition of the cost method that requires the recognition of return of capital situations:

> **Paragraph 4** The cost method is a method of accounting for an investment whereby the investment is recognized at cost. The investor recognizes income from the investment only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of investment and are recognized as a reduction of the cost of the investment.

2-52. As we believe that this is the appropriate conclusion with respect to situations where dividends exceed the investee's post acquisition income, we will provide coverage of the requirements of this definition. A simple example will serve to illustrate this situation:

Example On December 31, 2007, the Fastee Company has the following Shareholders' Equity:

Common Stock - No Par	$3,400,000
Retained Earnings	4,600,000
Total Shareholders' Equity	$8,000,000

On this date, the Fastor Company acquires 10 percent of Fastee's outstanding voting shares at a cost of $800,000. During 2008, Fastee has Net Income of nil and declares dividends of $400,000.

2-53. As Fastee had no Net Income in 2008, the 2008 dividends are being paid out of the December 31, 2007 Retained Earnings balance. From the point of view of Fastee, this is not a liquidating dividend. It is an ordinary dividend being paid on the basis of a Retained Earnings balance that is legally available for this purpose.

2-54. However, from the point of view of Fastor, the $40,000 dividend that they receive from Fastee represents a return of capital. This position is based on the fact that, when they paid $800,000 for their 10 percent share of Fastee, they acquired a 10 percent share of the $4,600,000 Retained Earnings balance that was present in Fastee's December 31, 2007 Balance Sheet. As this balance is being used by Fastee as the basis for the 2008 dividend payment, the $40,000 received by Fastor constitutes a return of part of the original investment and not investment income. Given this, the journal entry to record the receipt of the dividend is as follows:

Cash	$40,000	
Investment In Fastee		$40,000

Exercise Two-4

Subject: Cost Method Return Of Capital

On January 1, 2007, Jondy Ltd. acquires 5 percent of the voting shares of Montag Inc. for $785,000. The investment is classified as available for sale. The Montag shares do not trade in an active market. Jondy Ltd. has a December 31 year end.

During the year ending December 31, 2007, Montag has Net Income of $700,000 and pays dividends of $500,000. During the year ending December 31, 2008, Montag has Net Income of nil but continues to pay dividends of $500,000.

Provide the journal entries to record the preceding information on the books of Jondy Ltd.

End of Exercise. Solution available in Study Guide.

Subsidiaries

Definition

2-55. At one point in time, the *CICA Handbook* defined a subsidiary as an investee for which the investor held a majority of the outstanding voting shares. In general, this was a reasonable definition because majority ownership usually means that an investor company would be able to elect a majority of the investee company's board of directors and, thereby, exercise control over the operating, investing, and financing policies of the investee.

2-56. However, there was a problem in that, under this definition, no recognition was given to situations in which the investor company was able to exercise control without having majority ownership. The failure to recognize this possibility resulted in situations where an investor company which did, in fact, have full control of the investee company would account for its investment using methods that were intended for situations involving only significant influence. In other words, the original *Handbook* recommendation represented an emphasis on legal form, rather than economic substance.

2-57. The current Section 1590 corrects this situation. The definition of a subsidiary found in this Section is as follows:

> **Paragraph 1590.03(a)** A **subsidiary** is an enterprise controlled by another enterprise (the parent) that has the right and ability to obtain future economic benefits from the resources of the enterprise and is exposed to the related risks.

2-58. This represents an improved definition in that it places an emphasis on economic substance (the ability to control the investee) rather than on legal form (ownership of the majority of voting shares).

The Concept Of Control

Handbook Definition

2-59. In conjunction with the definition of a subsidiary, Section 1590 defines control as follows:

> **Paragraph 1590.03(b)** **Control** of an enterprise is the continuing power to determine its strategic operating, investing and financing policies without the co-operation of others.

Varying Interpretations

2-60. While this definition appears to be very straightforward, it is subject to varying interpretations. The most restrictive interpretation of this definition would be that control requires ownership of 100 percent of the outstanding shares of the investee. This is based on the fact that, as long as there are any shareholders in the investee company other than the controlling investor, corporate legislation will prevent the investor company from undertaking transactions that are harmful to the interests of that group.

2-61. For example, if the investor owns 100 percent of the outstanding shares, there is nothing to prevent the investor from selling products to the investee at prices in excess of fair market value. However, if there is a non-controlling (minority) interest present in the investee company, there are provisions in corporate legislation that would constrain the ability of the investor company to undertake such transactions.

2-62. While this very restrictive interpretation of control has some appeal from a legal point of view, it fails to recognize that control over the great majority of operating and financing decisions can be achieved with less than 100 percent ownership. This suggests the use of a less restrictive interpretation of control in practical situations.

2-63. An alternative interpretation of control could be based on the fact that corporate legislation generally requires a two-thirds majority vote for passage of special resolutions. Such transactions as changes in the corporate objectives, amalgamations with other companies, and other changes in the corporate charter would require such a super majority. This means that an interpretation of control based on two-thirds ownership of voting shares would have some appeal from a legal point of view. Again, however, this interpretation is too restrictive in that many of the operating and financing decisions could be controlled with less than two-thirds ownership of the investee company's voting shares.

Practical Interpretation

2-64. A more practical interpretation of control is based on the idea that, in terms of economic substance, the key factor is the ability of the investor company to determine policy for the great majority of operating and financing decisions that are made by the investee company. This ability is generally associated with simple majority ownership of outstanding voting shares. It is this interpretation of control that is contained in the *CICA Handbook* which states:

> **Paragraph 1590.08** The level of equity interest in one enterprise held by another leads to a presumption regarding control. An enterprise is presumed to control another enterprise when it owns, directly or indirectly, an equity interest that carries the right to elect the majority of the members of the other enterprise's board of directors, and is presumed not to control the other enterprise without such ownership. In a particular situation, these presumptions may be overcome by other factors that clearly demonstrate that control exists or does not exist. The greater the difference in an enterprise's voting interest from the 50 percent level, the more persuasive these other factors must be in overcoming the applicable presumption.

2-65. While this statement clearly establishes voting share ownership as the primary measure of control, it leaves open the possibility of other measures being used. Two examples of such other measures are cited:

> **Paragraph 1590.13(a)** Ownership of less than the majority of voting shares combined with an irrevocable agreement with other owners to exercise voting rights may result in majority voting power and may, therefore, confer control.

> **Paragraph 1590.13(b)** Control may exist when an enterprise does not own the majority voting interest if it has the continuing ability to elect the majority of the members of the board of directors through ownership of rights, options, warrants, convertible debt, convertible non-voting equity such as preferred shares, or other similar instruments that, if converted or exercised, would give the enterprise the majority voting interest.

2-66. An investor may find situations where its use of the resources of the investee company are subject to certain restrictions. Examples of this would be debt covenants which restrict the investee company's ability to pay dividends, or regulatory restrictions which control the prices that can be charged by the investee company.

2-67. Such normal business restrictions do not preclude control by the investor and the classification of the investee as a subsidiary. However, in some cases the restrictions may involve a transfer of voting rights and this could result in the investor no longer being able to exercise control.

2-68. Section 1590 also notes that a brief interruption of the power to determine strategic policies is not a loss of control. An example of this would be the appointment of a receiver to seize a specific group of assets in order to satisfy a creditor claim.

2-69. Also noted is the fact that the investor company can have control without choosing to exercise it on a day to day basis. In addition, control can be exercised in situations where the investor has obligations related to the investee that exceed the investee's resources. None of these conditions would prevent the investor's holding from being classified as a subsidiary.

2-70. However, there are situations in which the restrictions on the investor company's ability to exercise its ownership rights are so severe that control can no longer be considered present. An example of this would be a foreign investee operating in a country which places severe restrictions on the repatriation of earnings. In such cases, the investment would not be classified as a subsidiary, despite the presence of majority ownership of voting shares.

Indirect Ownership

2-71. The preceding discussion of control dealt only with situations in which the investor company had direct ownership of the investee company's outstanding voting shares. However, an investor company can have indirect control of another company, even in situations where the investor company owns none of the shares of that company. Two examples of such indirect control are provided in Figure 2-2.

2-72. In Example 1, P owns 60 percent of A. This would give P control over A and make this company a subsidiary. In turn, A owns 55 percent of B, giving A control and making B a subsidiary of A. In addition, P's control of A gives P indirect control over B, making B a subsidiary of P as well as a subsidiary of A.

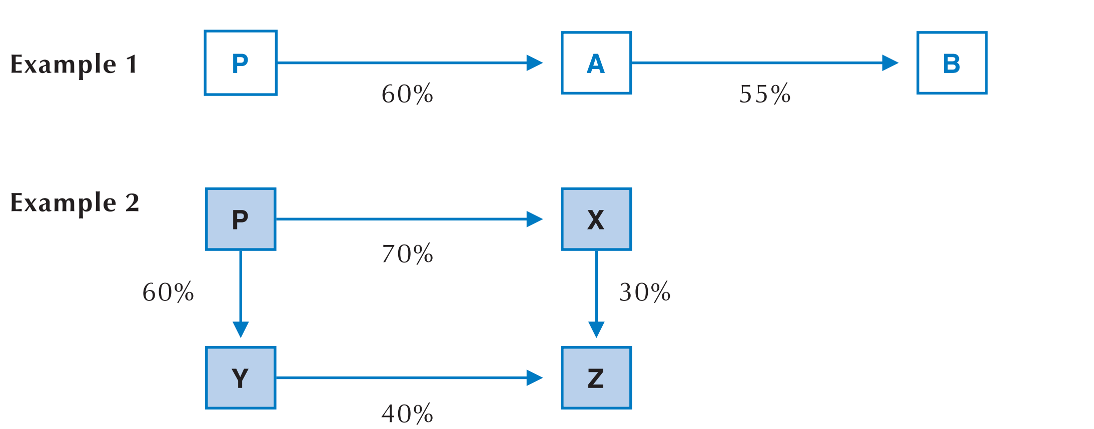
2-73. In Example 2, P controls both X and Y. Between them, these two companies own 70 percent of Z, giving them joint control over this company. Because P controls both X and Y, P has indirect control over Z. This means that Z, as well as X and Y are subsidiaries of P.

2-74. Both of the examples in Figure 2-2 would be referred to as multi-level affiliations. Even more complex relationships can develop if companies acquire shares of other companies that are above them in the chain of control. For example, Z might acquire some of the shares of X or P in Example 2. Shareholdings of this type are referred to as reciprocal shareholdings. The procedures to be used in dealing with both multi-level affiliations and reciprocal shareholdings are dealt with in Chapter 7, Advanced Topics In Consolidations.

2-75. A final point here relates to measurement based on indirect interests. Returning to Example 1, when we measure P's indirect interest in B, the resulting value will be based on the product of the ownership percentages. For example, P's interest in B's earnings is based on 33 percent [(60%)(55%)] of those earnings.

2-76. While such percentages must be used in measurement calculations, they have nothing to do with determining the existence of control. In general, control is based on majority ownership at each stage in the chain of ownership. The fact that an equitable

Figure 2-2
Examples Of Indirect Control



interest, as established by the product of the ownership percentages, is less than 50 percent has nothing to do with whether an indirect interest represents control.

Exercise Two-5

Subject: Indirect Ownership

Morton Ltd. owns 60 percent of the voting shares of Salt Inc. and 40 percent of the voting shares of Backy Inc. In addition, Salt Inc. owns 15 percent of the shares of Backy Inc. Briefly explain how Morton Ltd. should classify and account for its investments in Salt Inc. and Backy Inc.

End of Exercise. Solution available in Study Guide.

Disclosure

2-77. In the usual circumstances, control is identified by the presence of majority ownership of the voting shares of the investee. However, as we have noted in the preceding section, there is the possibility that control can be present without majority ownership, as well as the possibility that majority ownership will not provide control. As both of these situations are exceptions to a general rule, additional disclosure is required.

2-78. When control is present without the investor owning a majority of the investee's voting shares, the disclosure requirement is as follows:

> **Paragraph 1590.22** *When a reporting enterprise does not own, directly or indirectly through subsidiaries, an equity interest carrying the right to elect the majority of the members of the board of directors of a subsidiary, the reporting enterprise should disclose:*
> *(a) the basis for the determination that a parent-subsidiary relationship exists;*
> *(b) the name of the subsidiary; and*
> *(c) the percentage ownership (if any).* (January, 1992)

2-79. Alternatively, when there is majority ownership and the investee is not classified as a subsidiary, the following disclosure is required.

> **Paragraph 1590.23** *When a reporting enterprise owns, directly or indirectly through subsidiaries, an equity interest carrying the right to elect the majority of the members of the board of directors of an investee that is not a subsidiary, the reporting enterprise should disclose:*
> *(a) the basis for the determination that a parent-subsidiary relationship does not exist;*
> *(b) the name of the investee;*
> *(c) the percentage ownership; and*
> *(d) either separate financial statements of the investee, combined financial statements of similar investees or, provided all information significant to the consolidated financial statements is disclosed, condensed financial statements (including notes) of the investee.* (January, 1992)

Required Accounting Procedures For Subsidiaries

2-80. When an investor company has control over the operating, investing, and financing activities of an investee company, the two companies can normally be considered a single economic entity. In such circumstances, it is a well established practice for accountants to concentrate on the single economic entity, rather than on the separate investor and investee legal entities.

2-81. As the definition of a subsidiary is based on control, it is not surprising that consolidation is the required accounting method. The *CICA Handbook* makes the following recommendation with respect to the accounting treatment of subsidiaries:

Paragraph 1590.16 *An enterprise should consolidate all of its subsidiaries.* (January, 1992)

2-82. This is a very restrictive rule which provides no flexibility with respect to the consolidation of investments that are classified as subsidiaries. This reflects the fact that, under earlier rules which were less rigid, it appeared that investor companies used the available flexibility to enhance their consolidated statements by excluding certain subsidiaries (e.g., subsidiaries with large debt loads).

Consolidation Described

2-83. Consolidation is an accounting method which accounts for the investor and investee companies as if they were a single entity, adding together all of the assets, liabilities, expenses and revenues of the two companies. However, these procedures always begin with the single entity accounting records of the two companies. Because of this, the procedures required to adjust various asset values and to eliminate the effects of the different intercompany transactions are quite complex. So complex that they are the subject matter of Chapters 4 through 7 of this text. Given this complexity, we will not attempt to illustrate consolidation procedures in this Chapter.

2-84. We would note, however, that when consolidation procedures are applied, the Investment In Subsidiary account on the books of the investor, will always be replaced by the subsidiary's individual assets and liabilities. This means that no Investment In Subsidiary account will be included in the consolidated financial statements presented by the investor company. As a result, investor companies use a variety of different methods to account for the investment account in their single entity records.

2-85. Since the investment account will not be disclosed in the consolidated financial statements, the method by which this balance will be accounted for in the single entity records of the investee company is not subject to GAAP recommendations. This means that the Investment In Subsidiary account can be accounted for by any method that the investor company chooses to use. In order to simplify our presentation, we will generally account for investments in subsidiaries using the cost method.

Variable Interest Entities

The Problem

2-86. While we have only provided you with a superficial description of consolidation procedures, this should be sufficient for you to understand that these procedures will result in any debt that is carried in the financial statements of subsidiaries being included in the Balance Sheet for the consolidated group of companies.

2-87. Because of this debt disclosure problem, there has always been management resistance to consolidating some subsidiaries. In particular, if a parent company had invested in subsidiaries that were highly leveraged, management could present a consolidated Balance Sheet with considerably less debt if these subsidiaries could be accounted for on a cost or equity basis, rather than being incorporated into the consolidated financial statements.

2-88. At one point in time, this was fairly easy to do. The *Handbook* contained a strange little provision which allowed management to exclude a subsidiary from consolidation by simply stating a belief that this was not the most informative disclosure. This provision is no longer available. Under current standards, all subsidiaries must be consolidated. There are no convenient loopholes for excluding a subsidiary for which the parent has voting control.

2-89. Unfortunately, this did not solve the problem. Lawyers and accountants worked diligently to find ways around the consolidation rules and, not surprisingly, they were extremely successful. Methods were developed that allowed companies to achieve effective control over a business entity with little or no holdings of voting shares.

2-90. These arrangements generally involved the use of some type of contractual arrangement that left de facto control of a business in the hands of a corporation that did not have legal control through ownership of voting shares. As these arrangements were not covered by then existing accounting standards, there was no requirement that they be included in the consolidated financial statements.

2-91. This situation formed the basis for a number of widely publicized financial disasters, the most notable of which was the Enron collapse. Enron, as well as a number of other major corporations, was able to make investments that involved responsibility for an enormous amount of debt, without disclosing these liabilities in their consolidated financial statements. As a consequence, the unexpected collapse of these organizations was viewed, at least to some extent, as a failure of accounting standards.

The Solution - Accounting Guideline No. 15

2-92. As an almost direct response to these problems, the FASB issued Interpretation No. 46, *Consolidation Of Variable Interest Entities*. Following the U.S. lead, the AcSB issued Accounting Guideline No. 15 (AcG-15), "Consolidation Of Variable Interest Entities" in June, 2003.

2-93. AcG-15 is an extremely technical document. To cover its content in a meaningful fashion would require adding a full additional Chapter to this text. In our opinion, this would not be appropriate. However, we believe that it is useful for you to be aware of the general issues that are involved.

2-94. The basic idea behind the concept of a variable interest entity is that it is structured in such a manner that its equity interest does not appear to be in a position to exercise control. This would be the case if:

- The total equity interest is not sufficient to permit the entity to finance its activities without additional financial support (the guideline here is 10 percent).
- The equity investors lack any of the usual rights associated with equity interest. These would be the right to make decisions about the entity's activities, the obligation to absorb the expected losses of the entity, and the right to receive the expected residual returns of the entity.

2-95. Once a variable entity has been identified, the next step is to determine its primary beneficiary. This requires a complex analysis of which party to the arrangement has the obligation to absorb expected losses, benefit from residual returns, and make decisions about the activities of the entity.

2-96. Once a primary beneficiary has been identified, this corporation must include the assets, liabilities, expenses, and revenues of the variable interest entity in its consolidated financial statements.

> **CD-ROM Note** If you have an interest in this subject, we would refer you to our *Guide to Canadian Financial Reporting* which is included on the CD-ROM which accompanies this text. The Appendix to Chapter 14 contains detailed coverage of AcG-15, "Consolidation Of Variable Interest Entities".

Significantly Influenced Companies

Definition

2-97. The major focus of Section 3051, "Investments", is identifying and accounting for investments in significantly influenced companies. Given this, it is somewhat surprising that the Section does not define significant influence. Fortunately, a definition of this concept can be found in IAS No. 28, "Investments In Associates". The definition is as follows:

> **Paragraph 28-2 Significant Influence** is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies.
>
> **Note** In IASB standards, the term associated company has the same meaning as significantly influenced company in AcSB standards.

2-98. In contrast to this definitional approach, Section 3051 leaves the determination of significant influence as a matter of professional judgment. It does, however, indicate some of the factors that should be considered in this determination. These include:

- representation on the board of directors;
- participation in policy-making processes;
- material intercompany transactions;
- interchange of managerial personnel; and
- provision of technical assistance.

2-99. In addition, Section 3051 provides a quantitative guideline for determining significant influence. In Paragraph 3051.05, the AcSB indicates that, if the investor holds less than 20 percent of the voting interest in the investee, it is presumed that the investor does not have the ability to exercise significant influence. Also noted is the idea that holding 20 percent or more of the voting interest in the investee does not, in itself, confirm the ability to exercise significant influence.

2-100. In view of the fact that the existence of significant influence is clearly something that must be determined through the application of judgment on a situation by situation basis, it seems unfortunate that any particular percentage of share ownership was even mentioned. There is no logical reason to believe that 20 percent will be more effective in the determination of significant influence than any other arbitrarily determined percentage of share ownership. Therefore, it is possible to make a case that the exercise of judgment would have received more encouragement had this 20 percent guideline been omitted.

2-101. In applying professional judgment, representation on the board of directors is probably the most reliable indicator of the ability of the investor corporation to exercise significant influence. If the investor company is able to elect one or more members to the investee's board, it would generally be clear that influence is present.

2-102. The ability to get this representation is a function of the percentage of shares owned and the number of positions on the board. It is also dependent on the type of voting that is used by the investee company. For example, assume an investor owns 10 percent of the shares and there are 10 directors on the board. If the investee corporation uses cumulative voting, the investor will be in a position to elect one director. If the investee corporation uses non-cumulative voting, a majority group of shareholders can, in fact, elect the director that will fill each of the ten positions.

Required Accounting Procedures

General Rules

2-103. Under existing Canadian GAAP, most Balance Sheet items are carried at cost. While this traditional approach to asset and liability measurement is still pervasive in the *CICA Handbook*, there is growing use of fair value measurement. This is evident in recent pronouncements on goodwill and other intangible assets, impairment of long-lived assets, and the measurement of financial instruments.

2-104. In choosing an accounting method to apply to significantly influenced companies, the AcSB rejected both cost and fair value as a basis for the measurement of these assets, choosing instead an accounting method that is not in general use for any other type of asset. This choice is reflected in the following recommendation:

> **Paragraph 3051.06** *An investor that is able to exercise significant influence over an investee that is not a subsidiary as defined in Section 1590, "Subsidiaries", a joint venture as defined in Section 3055, "Interests In Joint Ventures", or a variable interest entity consolidated in accordance with AcG-15, "Consolidation of Variable Interest Entities", should account for the investment by the equity method.* (January, 2004)

2-105. Given the pervasive use of either cost or fair value measurement for other asset balances, why did the AcSB choose the equity method? Support for this choice can be found in the *CICA Handbook* as follows:

Paragraph 3051.11 In those situations in which the investor has the ability to exercise significant influence, shareholders would be informed of the results of operations of the investee, and it is appropriate to include in the results of operations of the investor its share of the income or losses of the investee. The equity method of accounting for the investment provides this information.

2-106. The choice of the equity method can also be explained in terms of why it is inappropriate to use either cost or fair value for the measurement of significantly influenced companies:

Rejection Of Cost Method The problem with using the cost method for investments that are subject to significant influence by the investor is that, under this method, investment income is equal to the investor's share of dividends declared by the investee. As dividend policy is one of the factors that could be subject to influence by the investor, this would leave the investor in a position of being able to have some degree of control over the amount of investment income that will be recorded. The fact that this amount could be manipulated by the investor would suggest that use of the cost method in these situations is not appropriate.

Rejection Of Fair Value Measurement The *CICA Handbook* defines fair value as the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. In the case of investments, fair value would often be based on day-to-day market prices for the investor's holdings. As these, in effect, represent liquidation values, they are probably not really representative of the value of the investments to a going concern. This would be particularly true in cases where the investment is part of a strategic plan. Given this consideration, the AcSB rejected the use of fair values for the general measurement of significantly influenced investees.

Equity Method

Defined

2-107. Section 3051 defines the equity method as follows:

Paragraph 3051.03(a) The **equity method** is a basis of accounting for investments whereby the investment is initially recorded at cost and the carrying value, adjusted thereafter to include the investor's pro rata share of post-acquisition earnings of the investee, computed by the consolidation method. The amount of the adjustment is included in the determination of net income by the investor, and the investment account of the investor is also increased or decreased to reflect the investor's share of capital transactions (including amounts recognized in other comprehensive income) and changes in accounting policies and corrections of errors relating to prior period financial statements applicable to post-acquisition periods. Profit distributions received or receivable from an investee reduce the carrying value of the investment.

2-108. Ignoring for the moment special disclosure requirements and the need for consolidation adjustments, we can describe the equity method either in terms of the value of the investment asset, or in terms of the investment income value. These descriptions would be as follows:

Investment (Asset) Value The investment account is initially recorded at cost. In each subsequent accounting period, it is adjusted up or down to reflect the investor company's share of the change in Retained Earnings of the investee company. This adjustment could also be described as a two stage process in which the investment account is increased (decreased) for the investor's share of the investee's Net Income (Net Loss) and reduced for the investor's share of the investee's dividends declared.

Investment Income Investment Income under the equity method is simply the investor company's share of the reported Net Income of the investee company.

Example - Basic Procedures

2-109. The example that follows involves no fair value changes, goodwill, or intercompany transactions. It will serve to illustrate the basic procedures associated with the equity method.

Example On December 31, 2006, the Stor Company purchases 30 percent of the outstanding voting shares of the Stee Company for $6 million in cash. Stor's 30 percent share ownership gives the Company significant influence over the operations of Stee. On this date, the carrying value of the net identifiable assets of the Stee Company total $20 million. All of the Stee Company's assets and liabilities have fair values that are equal to their carrying values. There are no intercompany transactions other than dividend payments during the three years subsequent to December 31, 2006. Dividends are declared on November 1 of each year and paid on December 1 of the same year.

Both companies have a year end of December 31. The Stee Company's Net Income and Dividends Declared and Paid for each of the three years are as follows:

Year	Net Income	Dividends Declared And Paid
2007	$2,000,000	$1,500,000
2008	500,000	1,500,000
2009	3,500,000	1,700,000
Totals	$6,000,000	$4,700,000

The Net Income of the Stee Company does not include any extraordinary items, results of discontinued operations, accounting changes, or capital transactions in any of the years under consideration. In terms of bookkeeping procedures used, Stor records the Stee dividends when received and adjusts accounts for its share of Stee's Net Income at the December 31 year end.

2-110. The journal entries for the Stor Company for the years 2006 through 2009 would be as follows:

December 31, 2006

Investment In Stee	$6,000,000	
Cash		$6,000,000

December 1, 2007

Cash	$450,000	
Investment In Stee		$450,000

(To record the receipt of 30 percent of the Stee Company's $1,500,000 of dividends declared as a reduction in Stor's equity interest in Stee.)

December 31, 2007

Investment In Stee	$600,000	
Investment Income		$600,000

(To record Stor's 30 percent share of Stee's $2,000,000 Net Income as an increase in Stor's equity interest in Stee and as investment income.)

December 1, 2008

Cash	$450,000	
Investment In Stee		$450,000

(To record the receipt of 30 percent of the Stee Company's $1,500,000 of dividends declared as a reduction in Stor's equity interest in Stee.)

December 31, 2008

Investment In Stee	$150,000	
Investment Income		$150,000

(To record Stor's 30 percent share of Stee's $500,000 Net Income as an increase in Stor's equity interest in Stee and as investment income.)

December 1, 2009

Cash	$510,000	
Investment In Stee		$510,000

(To record the receipt of 30 percent of the Stee Company's $1,700,000 of dividends declared as a reduction in Stor's equity interest in Stee.)

December 31, 2009

Investment In Stee	$1,050,000	
Investment Income		$1,050,000

(To record Stor's 30 percent share of Stee's $3,500,000 Net Income as an increase in Stor's equity interest in Stee and as investment income.) Note that the increase in the Investment in Stee account of $390,000 (-$450,000 + $600,000 - $450,000 + $150,000 - $510,000 + $1,050,000) is equal to 30 percent of the $1,300,000 ($6,000,000 - $4,700,000) increase in Stee's Retained Earnings since acquisition.

Exercise Two-6

Subject: Equity Method (See also Exercise Two-10)

On January 1, 2007, Plastor Inc. acquires 20 percent of the outstanding voting shares of Plastee Inc. for $300,000 in cash, a price that was equal to 20 percent of Plastee's net assets. The investment gives Plastor significant influence over Plastee.

During the year ending December 31, 2007, Plastee had Net Income of $150,000 and paid dividends of $100,000. In the year ending December 31, 2008, the Company had a net loss of $40,000 and paid dividends of $50,000. For the year ending December 31, 2009, Plastee's Net Income was $90,000 and it paid dividends of $80,000.

Provide Plastor's journal entries related to its Investment In Plastee for the three years ending December 31, 2007, 2008, and 2009 and calculate the balance in the Investment in Plastee account as at December 31, 2009.

End Of Exercise. Solution available in Study Guide.

Intra Statement Disclosure

2-111. Section 3051 requires that certain types of items that are included in the financial statements of the investee must be given separate disclosure, outside of the Investment Income total, in the financial statements of the investor. This recommendation is as follows:

> **Paragraph 3051.09** *In accounting for an investment by the equity method, the investor's proportionate share of the investee's discontinued operations, extraordinary items, changes in accounting policy, corrections of errors relating to prior period financial statements and capital transactions (including amounts recognized in other comprehensive income) should be presented and disclosed in the investor's financial statements according to their nature.* (April, 1996)

2-112. For certain types of items that may be included in the investee's separate financial statements, this recommendation requires the following special disclosures in the financial statements of the investor:

- Results of discontinued operations and extraordinary items must be shown in the investor's Statement Of Net Income as separate line items after Income Or Loss Before Discontinued Operations And Extraordinary Items.

- Adjustments resulting from investee accounting policy changes or accounting errors must be disclosed in the investor's Statement Of Retained Earnings.
- Investee capital transactions will be part of the investor's disclosure of changes in Shareholder's Equity.
- Items of Comprehensive Income recognized by the investee must be disclosed in the investor's Statement Of Comprehensive Income.

Example - Intra Statement Disclosure

2-113. The following example will illustrate the Paragraph 3051.09 recommendation with respect to the treatment of investee extraordinary items.

> **Example** On December 31, 2007, Nador Ltd. purchases 30 percent of the outstanding voting shares of Nadee Inc. for $6 million in cash. Nador's 30 percent share ownership gives it significant influence over the operations of Nadee. On this date, the carrying value of the net identifiable assets of Nadee Inc. total $20 million. All of Nadee's identifiable assets and liabilities have fair values that are equal to their carrying values.
>
> For the year ending December, 31, 2008, the Income Statements of the two Companies were as follows (Nador's Statement does not include Nadee's 2008 results):

	Nador Ltd.	Nadee Inc.
Sales	$3,500,000	$750,000
Expenses	3,000,000	550,000
Income Before Extraordinary Items	$ 500,000	$200,000
Extraordinary Loss	Nil	(80,000)
Net Income	$ 500,000	$120,000

> There are no intercompany transactions between Nador Ltd. and Nadee Inc. during 2008.

2-114. Nador Ltd.'s Income Statement for the year ending December 31, 2008, would be as follows:

Nador Ltd.
Income Statement
Year Ending December 31, 2008

Sales	$3,500,000
Ordinary Investment Income [(30%)($200,000)]	60,000
Total Revenues	$3,560,000
Expenses	3,000,000
Income Before Extraordinary Items	$ 560,000
Extraordinary Investment Loss [(30%)($80,000)]	(24,000)
Net Income	$ 536,000

2-115. As can be seen in the preceding Income Statement, the investee's extraordinary item would be disclosed as an extraordinary item in the Income Statement of the investor enterprise. This would be true even if some or all of the items were ordinary transactions from the point of view of the investor company. This is because they remain extraordinary transactions from the point of view of the investee and the related investment income.

Exercise Two-7

Subject: Equity Method Disclosure

On January 1, 2007, Clearly Inc. acquires 25 percent of the outstanding shares of Muddle Ltd. The consideration for the investment was $2 million in cash, plus Clearly Inc. shares with a fair market value of $500,000. At the time of this investment, the net book value of Muddle Ltd. was $10 million and all of the company's assets and liabilities had fair values that were equal to their carrying values. The investment gives Clearly significant influence over Muddle.

Both companies have a December 31 year end. During the year ending December 31, 2007, Muddle Ltd. has Net Income of $20,000 and pays no dividends.

During the year ending December 31, 2008, Muddle Ltd. has Income Before Discontinued Operations of $346,000. However, a loss on discontinued operations reduces Net Income to $46,000. Based on its recent history of profits, Muddle declares and pays dividends which total $103,000 during the year ending December 31, 2008.

Provide the journal entry that would be required on Clearly's books to account for its Investment In Muddle for the year ending December 31, 2008.

End of Exercise. Solution available in Study Guide.

EIC Abstract No. 8 - Losses Exceed Equity Investment Balance

2-116. A problem that can arise in the application of the equity method involves situations where the application of this method results in a credit balance for an investment.

Example On January 1, 2007, Duster Ltd. acquires 35 percent of the outstanding voting shares of Dustee Ltd. for $3,500,000 in cash. At the time of this acquisition, the net book value of Dustee Ltd. was $50 million. Duster Ltd. was able to acquire these shares at this price because it was anticipated that Dustee Ltd. was going to experience severe losses during the next two years. This expectation appears to be correct in that Dustee Ltd.'s loss for the year ending December 31, 2007 is $12 million.

2-117. Under the usual equity method procedures, the journal entry to reflect this result would be as follows:

Investment Loss [(35%)($12,000,000)]	$4,200,000	
Investment In Dustee		$4,200,000

2-118. The problem here is that this entry would create a credit balance of $700,000 ($4,200,000 - $3,500,000) in the Investment In Dustee account and this balance would have to be reported as a liability. Since equity investments in corporations are generally protected by limited liability, the recording of a liability in this situation would not be appropriate in normal circumstances. As a consequence, an investor company would usually stop recording further equity method losses when the related asset balance reaches nil.

2-119. However, the Emerging Issues Committee (EIC) was asked if there were any circumstances in which it would be appropriate to continue recording losses after an equity investment balance reached nil. Their response is reflected in EIC Abstract No. 8, "Recognition Of An Equity Accounted Investee's Losses In Excess Of The Investment", in which they indicate that continuing to record such losses would be appropriate if the investor was likely to share in them. In their view, this would be the case if any of the following conditions are present:

- the investor has guaranteed obligations of the investee; or
- the investor is otherwise committed to provide further financial support for the investee; or
- the investee seems assured of imminently returning to profitability.

2-120. The other issue dealt with in this EIC Abstract was the question of what disclosure should be provided in those cases where the investor does not continue to record equity method losses. In general, the EIC indicated that the information to be disclosed would be a matter of professional judgment, but could include:

- disclosure of unrecognized losses for the period and accumulated to date; and
- the investor's accounting policies with respect to the investment, including the policy to be followed should the investee return to profitability.

2-121. The EIC also indicated that, when losses have not been recorded on an investee that later returns to profitability, the investor should resume recognizing its share of those profits only after its share of the profits equals its share of the losses not recognized.

Exercise Two-8

Subject: EIC Abstract No. 8

On January 1, 2007, Ausser Ltd. acquires 40 percent of the outstanding voting shares of Aussee Inc. for $400,000. Ausser accounts for its Investment In Aussee using the equity method. Ausser has no commitments to provide any type of financial support for Aussee in subsequent fiscal periods.

During the year ending December 31, 2007, Aussee experiences a Net Loss of $1,500,000. During the year ending December 31, 2008, Aussee has Net Income of $800,000. No dividends were paid in either year.

Provide the journal entries to record Ausser's Investment Income (Loss) for the years ending December 31, 2007 and December 31, 2008 and calculate the balance in the Investment in Aussee account as at December 31, 2008.

End of Exercise. Solution available in Study Guide.

Loss Of Significant Influence

2-122. Over time, an investor may lose the ability to exercise significant influence over an investee. This could result from the sale of a portion of the investor's holding of voting shares, from changes in the ownership of other blocks of voting shares, or from changes in the economic relationship between the investor and the investee. Alternatively, an investor could move from having only significant influence to a situation where he has unilateral or joint control. Both of these possibilities are covered in the following recommendation:

Paragraph 3051.07 *When an investor ceases to be able to exercise significant influence over an investee, the investment should be accounted for in accordance with "Financial Instruments — Recognition And Measurement", Section 3855, unless the investor has obtained control or joint control, in which case the investor applies "Subsidiaries", Section 1590, "Interests In Joint Ventures", Section 3055, or AcG-15, "Consolidation of Variable Interest Entities", as appropriate.* (October, 2006)

2-123. In those cases where the investor moves from having significant influence to having control, consolidation will be required.

Example Tazer Ltd. has owned 40 percent of the outstanding voting shares of Tazee Inc. for several years. As Tazer has had significant influence during this period, Tazer has accounted for its investment in Tazee using the equity method. At the beginning of the current year, Tazer Ltd. acquires an additional 20 percent of the voting shares.

Analysis At this point, Tazer Ltd. has gained control over Tazee Inc. As control was acquired through multiple acquisition transactions, this would be a step-by-step purchase. The procedures for preparing consolidated financial statements in this type of situation are found in Section 1600 of the *CICA Handbook*. Our coverage of these rules is found in Chapters 5 and 6.

2-124. The other possibility that is contemplated in Paragraph 3051.07 is that the investor will move from having significant influence to having no influence. If the investment is a financial asset or a non-financial derivative, Section 3855 will apply. Under Section 3855, the accounting procedures to be used will be determined by how the investment is classified (e.g., available for sale vs. held for trading).

2-125. An issue that arises in this situation is what value should be used as the cost of the investment. This issue arises because the investment has been accounted for by the equity method and, given this, it is unlikely that it is being carried at its original cost. One solution to this problem would be a retroactive approach which restores the investment to its original cost.

2-126. However, the AcSB has rejected this approach. Paragraph 3051.16 indicates that, when an investor ceases to be able to exercise significant influence, cost is deemed to be the carrying value of the investment at the time that influence is lost.

> **Example** On January 1, 2005, Zador Ltd. acquires, for $250,000 in cash, 25 percent of the outstanding voting shares of Zadee Inc., an investment that gives Zador significant influence over the affairs of Zadee. At this time, the net assets of Zadee had a carrying value of $1,000,000. All of the individual assets and liabilities had fair values equal to their carrying value.
>
> During the period January 1, 2005 through December 31, 2007, Zadee had total Net Income of $240,000 and paid dividends of $90,000. Other than the dividend payments, there were no transactions between Zador and Zadee during this period.
>
> On January 1, 2008, Zador sells 80 percent of its holding of Zadee shares for $275,000. At this point, Zador is no longer able to influence the affairs of Zadee.
>
> **Analysis** The January 1, 2008 carrying value of Zador's investment in Zadee is $287,500 [$250,000 + (25%)($240,000 - $90,000)]. The sale of 80 percent of the shares for $275,000 will result in a gain of $45,000 [$275,000 - (80%)($287,500)].
>
> This will leave an investment with a carrying value of $57,500 [(20%)($287,500)]. Under Paragraph 3051.16, this will be deemed to be the cost of the remaining investment.
>
> As equity securities are viewed as financial assets, the remaining investment will fall within the scope of Section 3855. Under the provisions of that Section, the investment will be classified as held for trading or available for sale and accounted for at fair value in subsequent accounting periods.

Different Fiscal Periods

2-127. It would not be uncommon for a significantly influenced investee to have a fiscal period that is different from the fiscal period of the investor. While it would be possible for the investor to make an estimate of the investee's earnings for the period that coincides with their fiscal period, it is not a procedure that is required by the *CICA Handbook*. However, when the investor/investee fiscal periods do not coincide, additional disclosure is required as follows:

> **Paragraph 3051.10** *When the fiscal periods of an investor and an investee, the investment in which is accounted for by the equity method, are not coterminous, events relating to, or transactions of, the investee that have occurred during the intervening period and significantly affect the financial position or results of operations of the investor should be recorded or disclosed, as appropriate.* (August, 1978)

Consolidation Adjustments

2-128. With respect to the calculation of the investment income resulting from holding an investment in a significantly influenced company, Section 3051 makes the following recommendation:

> **Paragraph 3051.08** *Investment income as calculated by the equity method should be the amount necessary to increase or decrease the investor's income to that which would have been recognized if the results of the investee's operations had been consolidated with those of the investor.* (August, 1978)

2-129. The preparation of consolidated statements requires a number of adjustments to the single entity statements of the parent and subsidiary before the balances can be combined. In somewhat simplified terms, these are:

1. The elimination of intercompany expenses and revenues (e.g., intercompany sales and purchases).
2. The elimination of intercompany assets and liabilities (e.g., intercompany payables and receivables).
3. Amortization of fair value changes that were recognized when the subsidiary was acquired (the acquisition of a subsidiary is a business combination transaction). In some cases it will also be necessary to adjust for impairment of any goodwill that was recognized at the acquisition date.
4. The elimination of unrealized intercompany profits.

2-130. With respect to the first two items, they will have no influence on the determination of investment income under the equity method. They simply involve eliminating equal amounts of the relevant balances, and do not alter income or net asset values. As the equity method does not include investee expenses, revenues, assets, or liabilities in the financial statements of the investor, changes to these totals do not influence their presentation.

2-131. This is not the case with the last two items. Both the amortization of fair value changes and the elimination of intercompany profits change consolidated Net Income and, as a consequence, will influence the calculation of investment income under the equity method.

2-132. It is our opinion that discussion of these adjustments is not meaningful until you have a more complete understanding of consolidation procedures. As a consequence, we will continue our discussion of the equity method in both Chapter 5 (adjustments for fair value changes and goodwill impairment) and Chapter 6 (adjustments for unrealized intercompany profits).

Disclosure For Significantly Influenced Companies

2-133. Section 3051 contains several recommendations with respect to the disclosure of investments. They are as follows:

> **Paragraph 3051.25** *The basis of valuation of investments should be disclosed.* (January, 1973)

> **Paragraph 3051.26** *Investments in companies subject to significant influence, other affiliated companies and other investments should each be shown separately.* (January, 1992)

> **Paragraph 3051.27** *Income from investments in companies subject to significant influence, other affiliated companies and other investments should each be shown separately. Income calculated by the equity method should be disclosed separately.* (January, 1992)

> **Paragraph 3051.28** *When investments are accounted for by the equity method, disclosure should be made, in the notes to the financial statements, of the amount of any difference between the cost and the underlying net book value of the investee's assets at the date of purchase, as well as the accounting treatment of the components of such difference.* (January, 1973)

2-134. In addition to these specific requirements, Section 3051 makes several suggestions for additional information:

- When significantly influenced investees are important in the evaluation of enterprise performance, summarized information as to their assets, liabilities, and results of operations may be relevant.
- Disclosure of the investor's proportionate interest in the investees, as well as any contingent issuance of securities by an investee that might affect the investor's share of earnings, may be appropriate.
- Investments reported in the Balance Sheet and investment income reported in the Income Statement should be grouped in the same manner. This will assist users in understanding the relationship between reported income from investments and its source.
- Return on an investment includes both income flows and increases in its value. Given this, information additional to the carrying value of investments, for example, quoted market values, may be useful.

Joint Ventures

Definition

2-135. Section 3055 of the *CICA Handbook* defines a joint venture arrangement as follows:

> **Paragraph 3055.03(c)** A **joint venture** is an economic activity resulting from a contractual arrangement whereby two or more venturers jointly control the economic activity.

2-136. In order to understand this definition, a further definition is required:

> **Paragraph 3055.03(b)** **Joint control** of an economic activity is the contractually agreed sharing of the continuing power to determine its strategic operating, investing and financing policies.

2-137. The basic idea here is that control of the investee is shared by two or more investors. This means that, for an investee to be classified by an investor as a joint venture:

- that investor must participate in control of the investee; and
- no single investor can have unilateral control.

2-138. These concepts will be discussed more fully in Chapter 8 of this text.

Required Accounting Procedures For Joint Ventures

2-139. Section 3055 requires that joint ventures be accounted for using proportionate consolidation. The relevant recommendation is as follows:

> **Paragraph 3055.17** *Interests in joint ventures should be recognized in the financial statements of the venturer using the proportionate consolidation method.* (January, 1995)

2-140. Section 3055 does not contain any exceptions to this rule. We would note, however, that IAS No. 31, *Interests In Joint Ventures*, takes a different approach. This international standard allows enterprises to use either the equity method or proportionate consolidation to account for joint ventures. However, many analysts believe that the IASB will eventually reject the use of proportionate consolidation for this type of investment.

Proportionate Consolidation Described

2-141. Like full consolidation, proportionate consolidation adds together the assets, liabilities, expenses, and revenues of the investor and investee companies. The difference is that in full consolidation, 100 percent of the investee's financial statement items are added to those of the investor company, even in cases where ownership is less than 100 percent.

2-142. In contrast, proportionate consolidation, as its name implies, only adds in the investor's share of the investee assets, liabilities, expenses, and revenues. This reflects the view that, unlike the situation with subsidiaries, the investor company does not have full control over the investee. Control only extends to the investor's proportionate interest in the investee.

2-143. As is the case with full consolidation, the proportionate consolidation method does not lend itself to a brief, overview treatment. This method will, however, be given detailed treatment in Chapter 8 of this text.

Accounting Methods Summarized

2-144. The conclusions reached in Sections 1590, 3051, 3055, and 3855 on the appropriate accounting methods to be used for each classification of investments in equity securities is summarized in Figure 2-3.

Figure 2-3
Summary Of Accounting Methods For Investments In Equity Securities

Investment Classification	Accounting Method
Held For Trading	Fair Value Method - Changes In Net Income
Available For Sale:	
No Quoted Market Price	Cost Method
Quoted Market Price	Fair Value Method - Changes In Comprehensive Income
Significantly Influenced Companies	Equity Method
Joint Ventures	Proportionate Consolidation
Subsidiaries	Full Consolidation

2-145. It is interesting to note that a different method is used for each classification of investments in equity securities. This, of course, creates a fairly complex set of rules for dealing with these investments.

2-146. Given this situation, we would anticipate some simplification as international convergence progresses. Specifically, we are fairly confident that proportionate consolidation will disappear, with the equity method being prescribed for investments in joint ventures. There is also some possibility that enterprises will be given the option of using a fair value approach for significantly influenced companies.

Impairment

Significantly Influenced Companies

General Rules

2-147. Section 3051 recognizes that investments in significantly influenced companies may sometimes experience a loss in value that is unlikely to be reversed. To deal with such situations, it makes the following recommendation:

> **Paragraph 3051.18** *When there has been a loss in value of an investment that is other than a temporary decline, the investment should be written down to recognize the loss. The write-down should be included in the determination of net income and may or may not be an extraordinary item (see Section 3480, "Extraordinary Items").* (January, 1973)

2-148. Given the scope of Section 3051, it would appear that the application of this recommendation is limited to investments in significantly influenced investees and investments in non-financial assets. It would not apply to investments in subsidiaries, joint ventures, or variable interest entities. In addition, it would not be applicable to investments in financial assets that fall within the scope of Section 3855, rather than Section 3051.

2-149. In some cases the application of this recommendation will be fairly easy. If an investee is in bankruptcy, Paragraph 3051.18 is clearly applicable. Similarly, if the investor has agreed to sell its investment at a price that is less than the carrying value of the investment, there would be little question as to the need to reduce the carrying value of the investment.

2-150. However, the application of this provision would not be limited to the obvious applications as described in the preceding paragraph. A write-down could be appropriate if one or more of the following conditions was present:

- There was a prolonged period during which the quoted market value of the investment is less than its carrying value.
- The investee experienced severe losses in the current year or current and prior years.
- The investee experienced continued losses for a period of years.
- There was a suspension of trading in the securities.
- The investee experienced liquidity or going concern problems.
- The current fair value of the investment is less than its carrying value.

2-151. The application of these less objective criteria would, of course, involve the application of professional judgment.

Subsequent Recoveries

2-152. There are situations where an investment is written down to recognize a loss in value and, at a later point in time, the previously recognized loss is reversed. To deal with such cases, Section 3051 makes the following recommendation:

> **Paragraph 3051.19** *A write-down of an investment to reflect a loss in value should not be reversed if there is a subsequent increase in value.* (August, 1978)

2-153. From our point of view, it is difficult to understand why the same kind of evidence that was used to support the write-down of an investment could not be used to support the reversal of such a write-down. However, the approach taken here is consistent with the manner in which write-downs are dealt with for property, plant, and equipment under Section 3063, "Impairment Of Long-Lived Assets", and goodwill and other intangible assets under Section 3062, "Goodwill And Other Intangible Assets".

Other Classifications Of Investments

2-154. With respect to impairment of other classifications of investments in equity securities, our analysis is as follows:

> **Held-For-Trading Investments** These investments are carried at fair value, a measurement that would automatically pick up changes in fair value.

> **Available-For-Sale Investments At Fair Value** While these investments are also carried at fair value, the changes are generally included in Comprehensive Income. If impairment of these assets occurs, Paragraph 3855.A73 requires that the cumulative loss that has been recognized in Comprehensive Income be transferred to Net Income.

> **Available-For-Sale Investments At Cost** It would appear that these investments are subject to the same rules as significantly influenced companies.

> **Subsidiaries And Joint Ventures** There are no specific impairment provisions related to these investments. This likely reflects the fact that the assets and liabilities of the investee would be included in the required consolidated financial statements. Given this, these assets would be subject to the impairment provisions of the *CICA Handbook* related to specific types of assets (e.g., Section 3063 deals with the impairment of property, plant, and equipment).

Gains And Losses On The Sale Of Equity Investments

2-155. An investment in equity securities may consist of a group of identical securities which have been acquired at different points in time and, as a consequence, at different prices. When part of such a group is disposed of, some assumption must be made as to the flow of costs to be allocated to the sale. While there are a number of cost flow assumptions that could be used here, the *CICA Handbook* takes the position that average cost best reflects the gain or loss that would be recognized if the entire investment were disposed of:

> **Paragraph 3051.23** *For the purposes of calculating a gain or loss on the sale of an investment, the cost of the investment sold should be calculated on the basis of the average carrying value.* (January, 1973)

2-156. Note that this recommendation is only applicable to investments in equity securities that are covered by Section 3051, namely investments in significantly influenced companies. These would normally be carried by the equity method. However, as will be noted in the section which follows, there is a differential reporting option that allows such investments to be carried at cost.

2-157. We would also note that this recommendation is consistent with the required income tax treatment of gains and losses on identical properties (See Section 47 of the *Income Tax Act*).

Differential Reporting For Investments In Equity Securities

Qualifying Enterprises

2-158. In January, 2002, Section 1300, "Differential Reporting", was added to the *CICA Handbook*. Section 1300 provides qualifying enterprises with alternative differential reporting options for a group of specified *Handbook* recommendations. A qualifying enterprise is defined as follows:

> **Paragraph 1300.06** *An enterprise is a qualifying enterprise for purposes of the differential reporting options set out in an Accounting Recommendation, Accounting Guideline or Abstract of Issue Discussed by the Emerging Issues Committee when and only when:*
>
> *(a) it is a non-publicly accountable enterprise; and*
> *(b) its owners unanimously consent to the application of differential reporting options in accordance with paragraph 1300.13.* (January, 2002)

Held-For-Trading And Available-For-Sale Investments

2-159. There is no differential reporting option for held-for-trading investments. There is, however, an option for available-for-sale financial assets:

> **Paragraph 3855.86** *After initial recognition, an entity that qualifies under "Differential Reporting", Section 1300, may elect to measure available-for-sale financial assets that would otherwise be measured at fair value in accordance with paragraph 3855.66,* [**Byrd/Chen Note** See our Paragraph 2-30] *other than:*
>
> *(a) financial assets that have a quoted market price in an active market; and*
> *(b) financial assets that are designated and effective hedging instruments (see "Hedges", Section 3865);*
>
> *at cost or amortized cost.* (October, 2006).

2-160. This has no relevance for investments in equity securities because it does not cover available-for-sale investments that have a quoted market value. As we have noted earlier, when available-for-sale investments in equity securities do not have a quoted market value, they can be carried at cost by any enterprise, without regard to whether it qualifies for differential reporting.

Subsidiaries

General Recommendation

2-161. With respect to subsidiaries, Section 1590 includes the following differential reporting option:

> **Paragraph 1590.26** *An enterprise that qualifies under "Differential Reporting", Section 1300, may elect to use either the equity method or the cost method to account for subsidiaries that would otherwise be consolidated in accordance with paragraph 1590.16. All subsidiaries should be accounted for using the same method.* (January, 2002)

Other Requirements

2-162. When qualifying enterprises use this option, several other recommendations are applicable:

> **Paragraph 1590.27** *A loss in value of an investment in a non-consolidated subsidiary that is other than a temporary decline should be accounted for in accordance with the requirements of "Investments", paragraphs 3051.18-.22.* (January, 2002)

> **Paragraph 1590.28** *When an enterprise applies one of the alternative methods permitted by paragraph 1590.26, the financial statements should be described as being prepared on a non-consolidated basis and each statement should be labeled accordingly.* (January, 2002)

> **Paragraph 1590.29** *Investments in non-consolidated subsidiaries should be presented separately in the balance sheet. Income or loss from those investments should be presented separately in the income statement.* (January, 2002)

> **Paragraph 1590.30** *An enterprise that has applied one of the alternative methods permitted by paragraph 1590.26 should disclose:*
>
> *(a) the basis used to account for subsidiaries; and*
> *(b) the particulars of any shares or other securities issued by the enterprise that are owned by non-consolidated subsidiaries.* (January, 2002)

2-163. It is also noted that when subsidiaries are not consolidated, Section 3840, "Related Party Transactions", applies to those intercompany transactions that would have been eliminated on consolidation.

Significantly Influenced Companies

General Recommendation

2-164. Section 3051 contains the following differential reporting option for significantly influenced companies:

> **Paragraph 3051.32** *An enterprise that qualifies under "Differential Reporting", Section 1300, may elect to use the cost method to account for its investments in companies subject to significant influence that would otherwise be accounted for by the equity method in accordance with paragraph 3051.06. All investments in companies subject to significant influence should be accounted for using the same method.* (January, 2002)

Other Requirements

2-165. When this differential reporting option is used, Section 3051 contains two additional disclosure recommendations:

Paragraph 3051.33 *Investments in companies subject to significant influence accounted for using the cost method should be presented separately on the balance sheet. Income from those investments should be presented separately in the income statement.* (January, 2002)

Paragraph 3051.41 *An enterprise that has applied the alternative method permitted by paragraph 3051.32 should disclose the basis of accounting used to account for investments in companies subject to significant influence.* (January, 2002)

Exercise Two-9

Subject: Average Cost

Salson Inc. is a qualifying enterprise as defined in Section 1300 of the *CICA Handbook*, "Differential Reporting". With respect to its investments in equity securities, it has elected to carry its investments in significantly influenced companies using the cost method.

During the year ending December 31, 2007, Salson makes purchases of Tofal Ltd. shares that are sufficient to give Salson significant influence over the affairs of Tofal. These purchases are as follows:

	Number Of Shares	Total 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

Early in 2008, Salson Inc. sells 5,250 of its Tofal Ltd. shares at a price of $28 per share.

Determine the gain or loss that would be recorded by Salson Inc. on its sale of Tofal Ltd. shares.

Exercise Two-10

Subject: Cost Method Under Differential Reporting (See also Exercise Two-6)

On January 1, 2007, Plastor Inc. acquires 20 percent of the outstanding voting shares of Plastee Inc. for $300,000 in cash, a price that was equal to 20 percent of Plastee's net assets. The investment gives Plastor significant influence over Plastee. Plastor Inc. is a qualifying enterprise as defined in Section 1300 of the *CICA Handbook*, "Differential Reporting". With respect to its investments in equity securities, it has elected to carry its investments in significantly influenced companies using the cost method.

During the year ending December 31, 2007, Plastee had Net Income of $150,000 and paid dividends of $100,000. In the year ending December 31, 2008, Plastee had a net loss of $40,000 and paid dividends of $50,000. For the year ending December 31, 2009, Plastee's Net Income was $90,000 and it paid dividends of $80,000.

Provide Plastor's journal entries related to its Investment In Plastee for the three years ending December 31, 2007, 2008, and 2009 and calculate the balance in the Investment in Plastee account as at December 31, 2009.

End of Exercises. Solutions available in Study Guide.

Joint Ventures

General Recommendation

2-166. A differential reporting option is also provided in Section 3055 with respect to accounting for joint ventures:

> **Paragraph 3055.47** *An enterprise that qualifies under "Differential Reporting", Section 1300, may elect to use either the equity method or the cost method to account for its interests in joint ventures that would otherwise be accounted for using the proportionate consolidation method in accordance with paragraph 3055.17. All interests in joint ventures should be accounted for using the same method.* (January, 2002)

Other Requirements

2-167. Here again, when an alternative method is used, additional disclosure is required as follows:

> **Paragraph 3055.48** A loss in value of an interest in a joint venture not proportionately consolidated that is other than a temporary decline should be accounted for in accordance with the requirements of "Investments", paragraphs 3051.18-.22. (January, 2002)

> **Paragraph 3055.49** *Interests in joint ventures not proportionately consolidated should be presented separately in the balance sheet. Income or loss from those interests should be presented separately in the income statement.* (January, 2002)

> **Paragraph 3055.50** *An enterprise that has applied one of the alternative methods permitted by paragraph 3055.47 should disclose the basis used to account for interests in joint ventures.* (January, 2002)

2-168. Note that these are basically the same recommendations that apply when the differential reporting options are used to exclude subsidiaries from the consolidated financial statements. Also noted here is that the recommendations of Section 3840, "Related Party Transactions" are applicable to the intercompany transactions that would have been eliminated in the preparation of proportionately consolidated financial statements.

International Convergence

Held-For-Trading And Available-For-Sale Investments

Standards

2-169. The Canadian rules for these investments in equity securities are found in Section 3855, "Financial Instruments - Recognition And Measurement". The corresponding international standard is IAS No. 39, *Financial Instruments: Recognition And Measurement*.

Differences

2-170. With respect to investments in equity securities, the differences are as follows:

- IAS No. 39 uses the term "financial asset or financial liability at fair value through profit or loss" instead of "held for trading". While this term is more accurate, it does not exactly roll off the tongue.
- IAS No. 39 only allows investments that are not held for trading to be designated as such only under very limited circumstances. Section 3855 allows such designation without restrictions.
- IAS No. 39 requires available-for-sale investments to be measured at fair value unless that amount is not "readily determinable". Section 3855 allows the cost method when there is no "quoted market value". IAS No. 39 is different in that a fair value may be "readily determinable" when no "quoted market value" exists.

- IAS No. 39 does not provide an optional treatment for transaction costs. If the investment is measured at fair value with changes through income, these costs are charged to income. For other investments, these costs must be added to the amount initially recognized. In the case of available-for-sale assets, Section 3855 allows either treatment.
- IAS No. 39 requires the reversal of impairment costs if there is a recovery in value. This is neither required nor permitted under Section 3855.

Subsidiaries

Standards

2-171. There are three Canadian standards which deal with subsidiaries and consolidated financial statements:

Section 1581: Business Combinations This standard provides guidance on the recognition and measurement of a subsidiary's identifiable assets and goodwill at the time they are acquired.

Section 1590: Subsidiaries This standard defines subsidiaries and indicates the required accounting treatment.

Section 1600: Consolidated Financial Statements This standard provides the detailed procedures required in the preparation of consolidated financial statements.

2-172. The corresponding international material is found in two IFRSs:

IFRS No. 3: Business Combinations This standard corresponds to Section 1581.

IAS No. 27: Consolidated And Separate Financial Statements This standard's content covers the same ground as Section 1590 and Section 1600.

Differences

2-173. The major differences between the Canadian and the international standards are as follows:

Section 1581 The AcSB's Implementation Plan indicates that Section 1581 and IFRS No. 3, *Business Combinations*, are converged except for the following:

- IFRS No. 3 requires that the acquirer to recognize the acquiree's identifiable assets, liabilities, and contingent liabilities at their fair values at the acquisition date, rather than the acquirer's share only. This results in any non-controlling interest in the acquiree being stated at the non-controlling interest's portion of the net fair values of those items.
- IFRS No. 3 requires the acquisition date to be the date on which the acquirer obtains control over the acquired entity or business.
- IFRS No. 3 requires that shares issued as consideration be measured based on their fair value at the date of the exchange transaction.
- IFRS No. 3 does not allow the use of the acquirer's share of the fair value of the net assets or equity instruments acquired if that is more reliably measurable, in determining the cost of a business combination.
- IFRS No. 3 requires that contingent consideration be recognized when it is probable that it will be paid and can be reliably measured.
- IFRS No. 3 requires that any negative goodwill be recognized immediately in profit or loss.

From the point of view of the material in this text, the most important of these differences is the first one. This will require a major change in the way consolidated financial statements are prepared in Canada. The IASB's alternative approach will be illustrated in Chapters 4, 5, and 6.

Section 1590 The AcSB's Implementation Plan indicates that Section 1590 and IAS No. 27, *Consolidated And Separate Financial Statements*, are converged, except that IAS No. 27 assesses control at a point in time, whereas Section 1590 assesses control based on an entity's continuing ability to make strategic policy decisions.

Section 1600 The AcSB's Implementation Plan indicates that Section 1600 is converged with IAS No. 27, *Consolidated And Separate Financial Statements*, and IFRS No. 3, *Business Combinations*, except for the following:

- The IFRSs have less detail on dilution gains and step acquisitions.
- The IFRSs require non-controlling interests to be shown within equity, separately from the parent shareholders' equity. As a consequence, non-controlling interests' shares of Net Income are reported as allocations within equity, rather than as income or expense items in the Income Statement.
- The IFRSs require non-controlling interests to be stated at their proportion of the net fair value of the acquired net assets, rather than at the subsidiary's carrying amount.

Significantly Influenced Companies

Standards

2-174. The Canadian rules for these investments in equity securities are found in Section 3051, "Investments". The corresponding international standard is IAS No. 28, *Investments In Associates*.

Differences

2-175. There is a difference in terminology in that IAS No. 28 refers to "associated companies" while Section 3051 refers to "significantly influenced companies". However, these two terms have the same meaning.

2-176. There is also a difference in the way that Section 3051 and the relevant international standards deal with impairment:

- The IFRSs require an impairment to be recognized when the recoverable amount of an asset is less than the carrying amount, rather than when there is a significant or prolonged decline in value below the carrying amount.
- The IFRSs determine the impairment loss as being the excess of the carrying amount above the recoverable amount (calculated as the higher of fair value reduced by costs to sell and value in use, calculated as the present value of future cash flows from the asset).
- The IFRSs require the reversal of an impairment loss when the recoverable amount increases.

Joint Ventures

Standards

2-177. The Canadian rules for these investments in equity securities are found in Section 3055, "Interests In Joint Ventures". The corresponding international standard is IAS No. 31, *Interests In Joint Ventures*.

Differences

2-178. IAS No. 31 allows the use of either proportionate consolidation or the equity method to account for joint ventures. Section 3055 requires proportionate consolidation and does not allow the use of the equity method.

Investments In Canadian Practice

Statistics From Financial Reporting In Canada

2-179. Our source for statistics on Canadian practice is the 2006 edition of *Financial Reporting In Canada*. This publication surveys the 2005 annual reports of 200 Canadian companies and, as a consequence, it contains no information in Section 3855. In addition, most of the companies surveyed were using the now withdrawn Section 3050, "Long-Term Investments". However, with respect to significantly influenced companies, Section 3050 and Section 3051 have few differences. As a consequence, it is useful to provide you with some information from this publication, despite the fact that it does not reflect current Canadian practices.

2-180. Of the 200 companies surveyed for the 2006 edition of *Financial Reporting in Canada*, 122 disclosed the presence of long-term investments other than joint ventures in their 2005 annual reports. With respect to the valuation of these investments, 68 companies used both cost and equity, 22 used cost only, and 11 used equity only. The remaining 21 companies did not disclose the basis of valuation.

2-181. Of the 122 companies that disclosed the presence of long-term investments other than joint ventures, 78 segregated investment assets by type of investment. Only 52 of the 122 companies disclosing the presence of long-term investments segregated investment income by type.

> **CD-ROM Note** If you are interested in more information on statistics on this subject, the CICA's *Financial Reporting in Canada* is available on the CD-ROM which is included with this text.

Example From Practice

27-182. The following example is from the annual report of Shaw Communications Inc. for the reporting period ending August 31, 2005. This example illustrates detailed disclosure of long-term investments. Included is disclosure of fair market values, company names, dilution gains, and impairment losses. Note that this disclosure is based on the requirements of the now superseded Section 3050, "Long-Term Investments".

Notes To Financial Statements

(all amounts in thousands of Canadian dollars except per share amounts)

Note 1 Significant Accounting Policies (in part)

Investments

Investments in other entities are accounted for using the equity method or cost basis depending upon the level of ownership and/or the Company's ability to exercise significant influence over the operating and financial policies of the investee. Equity method investments include GT Group Telecom Inc. ("GT") until February 4, 2003 (at which time GT was reorganized and resulted in the disposition of the Company's interest in GT), The Biography Channel (Canada) Corp., MSNBC Canada Holdings Corp. and 3773213 Canada Inc. (G4TechTV Canada). Investments of this nature are recorded at original cost and adjusted periodically to recognize the Company's proportionate share of the investees' net income or losses after the date of investment, additional contributions made and dividends received. When net losses from an equity accounted for investment exceed its carrying amount, the investment balance is reduced to zero and additional losses are not provided for unless the Company is committed to provide financial support to the investee. The Company resumes accounting for the investment under the equity method when the entity subsequently reports net income and the Company's share of that net income exceeds the share of net losses not recognized during the period the equity method was suspended. Investments are written down when there is clear evidence that a decline in value that is other than temporary has occurred.

When an equity accounted for investee issues its own shares, the subsequent reduction in the Company's proportionate interest in the investee is reflected in income as a deemed dilution gain or loss on disposition.

Note 5 Investments and Other Assets

	2005 $	2004 $
Investments, at cost net of write-downs:		
Canadian Hydro Developers, Inc. ("Canadian Hydro")		
(market value $58,920; 2004 – $26,033)	24,432	19,267
Motorola, Inc. ("Motorola")		
(market value – 2004 – $44,113)	—	8,925
Q9 Networks Inc. ("Q9 Networks")		
(market value – $2,731; 2004 – $3,710)	1,074	2,500
Investments in private technology companies	2,126	4,063
Investments at equity:		
Investments in specialty channel networks	668	702
Other assets:		
Employee home relocation mortgages		
and loans [note 18]	6,246	6,899
Other	1,683	1,609
	36,229	43,965

Canadian Hydro

Canadian Hydro, a Canadian public corporation, develops and operates electrical generating plants. A summary of the holdings in Canadian Hydro is as follows:

	2005	2004
	(number of shares/warrants)	
Shares	12,430,364	10,330,364
Warrants – vested – exercise price of $2.35	—	1,100,000
	12,430,364	11,430,364

Motorola

In 2005 the Company settled an equity forward sales contract on the Motorola investment resulting in the realization of a $31,018 pre-tax gain. The Motorola investment had been pledged as collateral for the Zero Coupon Loan (see note 11) and the proceeds of settlement were used to repay the Zero Coupon Loan and accrued interest.

Q9 Networks

During the current year, the Company sold 367,880 shares resulting in a pre-tax gain of $840. In September 2005, the Company sold the remaining 277,281 shares resulting in a pre-tax gain of $1,690.

Write-downs of investments at cost

	2005 $	2004 $	2003 $
Canadian Hydro	—	—	4,925
Other public companies	—	—	27
Specialty channel network	—	401	—
Private companies	1,937	250	10,048
	1,937	651	15,000

Investments at equity
The Company has a one-third interest in three specialty channel networks.

Equity income (loss) on investees consists of the following:

	2005 $	2004 $	2003 $
Specialty channel networks	(346)	(272)	(1,898)
Other	60	22	(23)
	(286)	(250)	(1,921)

Gain on redemption of SHELS
In prior years, the Company issued equity instruments which were collateralized by certain investments. In 2003 the Company settled these equity instruments by delivery of the underlying investments and recorded gains as follows:

Equity instrument	Delivery of underlying security	2005 $	2004 $	2003 $
Series III&IV SHELS	1,452,506 shares of Liberate Technologies	—	—	75,342
Series V SHELS	5,326,827 shares of Terayon Communications Systems	—	—	44,179
		—	—	119,521

Note 19 Financial Instruments (in part)
(ii) Investments and other assets

a) The fair value of publicly traded shares included in this category is determined by the closing market values for those investments. The fair value of investments subject to forward sale agreements, which are pledged as collateral for the Zero Coupon Loan and match the maturity of the loan, are valued at the proceeds received on the loan plus accrued interest thereon.
b) The carrying value of other investments in this category approximates their fair value.

CD-ROM Note If you are interested in more examples of disclosure of investments, the CICA's *Financial Reporting in Canada* is available on the CD-ROM which is included with this text.

Additional Readings

2-183. In writing the material in the text, we have incorporated all of the relevant *CICA Handbook* recommendations, as well as material from other sources that we felt to be of importance. This includes some, but not all, of the EIC Abstracts that relate to investments in equity securities, as well as material from international accounting standards.

2-184. While this approach meets the needs of the great majority of our readers, some of you may wish to pursue this subject in greater depth. To facilitate this, you will find a fairly comprehensive list of additional readings at the end of each relevant Chapter in our *Guide To Canadian Financial Reporting*.

CD-ROM Note Our *Guide To Canadian Financial Reporting* is available on the CD-ROM which is included with this text.