CHAPTER 2

Temporary, Portfolio, and Significant Influence Investments

CHAPTER OUTLINE

LEARNING OBJECTIVES

After studying this chapter, you should be able to do the following:

- Describe the broad relationship between all the relevant sections of the *CICA Handbook* that comprise the "big picture."
- Distinguish between temporary, portfolio, and significant influence investments.
- Apply the basic concepts behind the cost and equity methods.
- Prepare equity method entries to amortize the purchase discrepancy.
- Prepare equity method journal entries to reflect unrealized profits on asset transfers.

Share Capital Investments — The Big Picture

This is the first of 10 chapters that make up a single accounting topic. This topic is described by the following question: How should a Canadian company report, in its financial statements, an investment in the share capital of another company? There are five types of investment in shares:

- Temporary.
- Portfolio.
- Significant influence.
- Control.
- Joint venture.

While it sounds simple, this is a complex topic, and you will have to read carefully and manipulate numbers extensively if you are to achieve a thorough understanding of the concepts and issues involved.

A major subset of this large topic is the preparation of consolidated financial statements, which in itself is fraught with complexity. There is always a danger that, in attempting to absorb a large amount of new material, you will concentrate on the details to the point of losing sight of the big picture. It is important that you don't lose sight of the forest when you study the trees.

Before proceeding with our examination of the "trees," it would be useful to look at this "forest." The question posed above provides a path into the forest. The accounting principles involved with this question are contained in numerous sections of the *CICA Handbook* and in the statements issued by the Emerging Issues Committee (EIC) of the CICA.

We will use a summarized balance sheet to illustrate the question, and then outline the possible answers that are contained in the *Handbook* sections.

Shown below is the balance sheet of J Company Ltd.:

J COMPANY LTD.
BALANCE SHEET

Miscellaneous assets	$ XXX	Liabilities	$ XXX
Investment in shares		Shareholders' equity	
of K Corporation	**XXX**	Capital stock	XXX
		Retained earnings	XXX
	$ XXX		$ XXX

Dollar amounts have been omitted from the table because our focus is on the amount that should be shown for "Investment in shares of K Corporation."

Four *Handbook* sections are directly related to providing an answer to this question; a further seven sections and numerous Emerging Issues Abstracts must also be considered. A brief summary of the provisions contained in the first four sections is presented next.

Directly Related *Handbook* Sections

1. Section 1590: "Subsidiaries"

If J Company controls K Corporation, then J Company is called a parent company and K Corporation is called a subsidiary, and GAAP requires the preparation of consolidated financial statements by J Company. This involves removing the investment in K Corporation from J Company's balance sheet and replacing it with the assets and liabilities from the balance sheet of K Corporation. This process is illustrated at the end of Chapter 3 and in the chapters that follow it.

Control exists if J Company has the continuing power to determine the strategic operating, investing, and financing policies of K Corporation without the co-operation of others.[1] Control would generally be presumed if J Company's investment consists of a majority of the voting shares of K Corporation; but as we will see in later discussions,[2] control can exist with smaller holdings and does not necessarily exist with majority holdings.

If the investment is not one that produces control, then *CICA Handbook*, sections 3010, 3050, and 3055 must be examined to determine the required financial reporting.

2. Section 3010: "Temporary Investments"

These are transitional investments in marketable debt and equity securities that have been made to obtain a temporary return on surplus cash. Investments of this type are shown in the current assets section of the balance sheet, often described as "marketable securities." They are initially recorded at cost and subsequently are valued at the lower of cost or market. Interest accruing on debt securities and dividends received from investments in equity securities are reported as revenue. This topic is covered in more detail later in this chapter.

3. Section 3050: "Long-term Investments"

This section describes the financial reporting required for two other types of investments: significant influence and portfolio.

Significant Influence This refers to an investment that does not convey control and is not an investment in a joint venture, but that does allow the investor to exercise significant influence over the strategic operating, investing, and financing policies of the investee. The *Handbook* indicates that an investment of 20 percent or more of the voting shares of K Corporation, without control being present, would be presumed to be a significant influence investment, unless there is evidence to the contrary. Such evidence is discussed later.

If J Company's investment is one of significant influence, it must be reported by the equity method. Thus the investment is initially recorded at cost and then adjusted thereafter to include J Company's pro rata share of the earnings or losses of K Corporation adjusted for the purchase discrepancy[3] and the elimination and subsequent recognition of all intercompany profits that occur as a result of transactions between the two companies. Dividends received from K Corporation are recorded as a reduction of the investment.

Portfolio A portfolio investment is a long-term investment that is not an investment in a joint venture or partnership and that does not give significant influence or control. It is presumed that an investment of less than 20 percent of the voting shares of K Corporation is a portfolio investment unless there is evidence that clearly indicates the presence of significant influence.

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[1] *CICA Handbook*, paragraph 1590.03.

[2] The concept of control is discussed in greater detail in Chapter 4.

[3] The concept of a purchase discrepancy is discussed later.

A portfolio investment is reported by the cost method, whereby only dividends received are reported as revenue.

The accounting for portfolio and significant influence investments will be illustrated later.

4. Section 3055: "Investments in Joint Ventures"

If the investment is not one of the four just described, it may possibly be a joint venture investment if the following general provisions of this section are satisfied.

For a joint venture to exist, the owners (the venturers) must have made a contractual arrangement that establishes joint control over the venture. Under such joint control, each venturer shares in some manner the power to determine strategic operating, financing, and investing policies, and no single venturer is able to unilaterally control the venture.

Under this section, J Company Ltd. (the "venturer") reports its investment in K Corporation Ltd. (the "venture") by consolidating K Corporation using the proportionate consolidation method. This method involves applying the proprietary theory of consolidation and is illustrated in Chapter 10.

Other Related *Handbook* Sections

The remaining seven important *Handbook* sections are directly related to the four sections that were just outlined and are discussed briefly below.

5. Section 1581: "Business Combinations"

A business combination is an economic event whereby one company acquires net assets that constitute a business or equity interests of another company and, as a result, obtains control over that company.

J Company Ltd. obtains *control* over the net assets of K Corporation by either:

(a) investing in the voting shares of K Corporation (a parent–subsidiary relationship), or

(b) purchasing the net assets of K Corporation (not a parent–subsidiary relationship).

Prior to June 2001, there were two distinct methods of accounting for business combinations. Depending on the particular circumstances, a business combination was accounted for in accordance with the *purchase method* or the *pooling of interests method*. When the purchase method was used, any resulting goodwill had to be amortized over a maximum period of 40 years. On June 30, 2001, major changes were made to business combination accounting. Pooling of interests was banned, leaving only the purchase method as a means of accounting for a business combination. In addition, the periodic amortization of purchased goodwill was discontinued in favour of the regular testing of goodwill for impairment. Business combination accounting is explained in Chapter 3.

It should be noted that the term "control" is also used in Section 1590. On the date that a parent–subsidiary relationship is established, a business combination has occurred.

6. Section 1600: "Consolidated Financial Statements"

This section details the accounting principles to be followed in preparing consolidated financial statements. The pronouncements of this section will receive extensive attention in the chapters that follow.

7. Section 1625: "Comprehensive Revaluation of Assets and Liabilities"

A comprehensive revaluation of the assets and liabilities of an enterprise can take place under the provisions of this section when:

(a) there has been a change in control because all or virtually all of the equity interests of the enterprise have been acquired by another enterprise, *or*

(b) the enterprise has been subject to a financial reorganization, and as a result the previous owners have lost control.

A revaluation under the first condition is permitted but not required, and is the application of "push-down" accounting. Under the second condition, which arises when the entity is in serious financial distress, a revaluation is mandatory. The accounting involved for comprehensive revaluations will be discussed in Chapter 11.

8. Section 1650: "Foreign Currency Translation"

This section deals with the translation of the financial statements of foreign investees, subsidiaries, and joint ventures, and with the translation of transactions denominated in foreign currencies.

Provisions of this section would apply if:

(a) K Corporation was located in a foreign country and/or prepared its financial statements in a foreign currency, or

(b) J Company Ltd. had borrowings or lendings and/or export/import activities denominated in foreign currencies.

Chapters 12 and 13 examine the accounting concepts involved here.

9. Section 1701: "Segment Disclosures"

Consolidated financial statements may result in the aggregating of the statements of companies in diverse businesses located in countries throughout the world. Disaggregation into operating segments and disclosures about products, geographic areas, and major customers is required by this section in order to improve the information content of the consolidated statements. Segment disclosures are discussed in Chapter 10.

10. Section 3465: "Income Taxes"

This new section adds some complications to the asset valuations associated with business combinations and consolidated financial statements. These provisions, which became effective on January 1, 2000, are discussed in Chapter 10.

11. Section 3475: "Discontinued Operations"

This section discusses the reporting requirements when a business segment, such as a subsidiary or joint venture, has been sold.

This topic is well covered in most intermediate accounting texts.

Related EIC Abstracts

In 1988, the CICA formed its Emerging Issues Committee (EIC) to recommend the appropriate accounting for emerging accounting issues. These are issues that either have not been covered by existing *Handbook* sections or for which additional guidance is required regarding the appropriate accounting method. While the pronouncements of this committee do not carry the same degree of authority as the *Handbook* sections, they are considered to be within the broad domain of generally accepted accounting principles in Canada.[4] A number of the abstracts issued by the EIC are related to the *Handbook* sections outlined in this introduction. The appendix at the end of this chapter lists these particular abstracts and the *Handbook* sections to which they relate.

The big picture, the details of which are contained in a number of later chapters in this book, has been outlined in this overview. You will find it useful to refer to this overview and the "forest" described as you study the material that follows. We will now begin our examination of the "trees."

This chapter examines situations where a share investment does not constitute control or joint control. Section 3010, "Temporary Investments," and Section 3050, "Long-term Investments," cover these situations.

Temporary Investments

Section 3010, "Temporary Investments," deals with investments in equity or debt instruments that can be promptly liquidated, and where the intent of management is to invest surplus cash in the short term. Investments of this type are reported in the current assets section of the balance sheet, often right after (or occasionally combined with) cash assets. Because of its nature, this type of investment would normally contain highly liquid debt instruments rather than the common share investments that are our main focus in this chapter. These investments are measured at acquisition cost except when the market price has declined below cost. When this is the case, the investments are written down to market, and the resultant loss is reflected in income. When market is above cost, the market price is disclosed in the financial statements but no write-up is permitted.[5]

While the *Handbook* is silent on the details of application, it is considered acceptable to apply these concepts either to individual securities or, alternatively, on a portfolio basis. The individual basis is more conservative; it requires that individual investments be written down if their market prices have declined below cost, but ignores other investments whose market price is greater than cost. The portfolio basis compares the total cost with the total market price for all the different investments and adjusts the portfolio total to market by means a valuation allowance. This allowance has to be adjusted each year as the composition of the portfolio changes.

Income from temporary investments is reflected in the income statement and consists of interest earned, dividends received or receivable, and realized gains and losses from the sale of investments. The income statement also reflects any unrealized losses resulting from write-downs to market.

Long-term Investments

Section 3050, "Long-term Investments," covers two types of share investments and describes two methods of accounting for them. Here management's intent is to hold the investments for the long term, and for that reason they are reported as noncurrent assets on the balance sheet. The two types are portfolio investments and significant influence investments; the two distinct accounting methods are the cost method and the equity method.

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4 *CICA Handbook*, paragraph 1000.60.

5 This may change when a new standard on financial instruments is released by CICA.

Portfolio Investments

The *Handbook* defines a portfolio investment by describing what it is not rather than what it is. Basically, the *Handbook* says that portfolio investments are not control or joint venture investments and, furthermore, that they do not allow the reporting enterprise to exercise significant influence over the investee corporation. They are also not temporary investments because they are long term in nature. The *Handbook* provides quantitative guidelines, which suggest that a holding of less than 20 percent of the voting shares indicates a portfolio investment. A block of shares of this size probably would not allow the investor to elect any members to the board of directors of the investee corporation; because of this, it probably cannot exert any influence on the decision-making processes of that company. However, 20 percent is only a guideline, and an examination of the facts may suggest some other type of investment. For example, if the investee's shares are widely distributed, and all the other shareholders hold very small blocks of shares and display indifference as to the make-up of the board of directors, an investment of less than 20 percent may be considered a significant influence investment. This certainly could be the case if some of the remaining shareholders gave the investor proxies to vote their shares. Another situation where an investment consisting of 15 percent in the voting shares of an investee would not be a portfolio investment (or significant influence) would occur when the investee was a joint venture.

Portfolio investments are reported using the cost method. Under this method the amount in the investment account remains at the original acquisition cost, and the investor's share of the dividends received is reported as revenue. There are only two exceptions to this:

1. Any dividends received that are greater than the total of the net incomes earned since acquisition are treated by the investor as a reduction in the investment account. Dividends are a company's method of distributing earnings to its owners; it follows that a company cannot distribute as income more than it has earned. When it does so it is really returning to its owners a portion of the capital that they have contributed (a liquidating dividend).
2. If the market price drops permanently below the original acquisition cost, the investment must be written down to market and the loss reflected in income. If the market subsequently recovers, a write-up is not permitted. Note that the market decline must be permanent for this treatment to be applicable, whereas a temporary investment must be reported at the lower of cost or market.

Illustration On January 1, Year 1, Jenstar Corp. purchased 10 percent of the outstanding common shares of Safebuy Company at a cost of $95,000. Safebuy reported net incomes and paid dividends at the end of each year as follows:

	Net income	*Dividends*
December 31, Year 1	$100,000	$75,000
December 31, Year 2	65,000	75,000
December 31, Year 3	30,000	75,000

Utilizing the cost method to account for its investment, Jenstar would make the following journal entries:

Jan. 1, Year 1		
Investment in Safebuy	95,000	
Cash		95,000
To record the acquisition of 10% of Safebuy's shares		

Dec. 31, Year 1		
Cash	7,500	
Dividend revenue		7,500
Receipt of dividend from Safebuy		
Dec. 31, Year 2		
Cash	7,500	
Dividend revenue		7,500
Receipt of dividend from Safebuy		
Dec. 31, Year 3		
Cash	7,500	
Dividend revenue		4,500
Investment in Safebuy		3,000
Receipt of dividend from Safebuy		

The entries in years 2 and 3 need further clarification. The dividends paid in Year 2 were greater than the net income for that year, and from Jenstar's perspective it is possible that a portion of the dividend received should be recorded as a reduction in the investment account. However, total net income earned since acquisition is greater than total dividends paid since that date, so the dividends received are considered revenue in both years. In Year 3 the dividends paid were greater than the net income earned, and so we again have to compare total net income earned with total dividends paid. Total income since acquisition date amounts to $195,000, while dividends in the same period are $225,000. Therefore, $30,000 of these dividends are really liquidating dividends from the point of view of Jenstar. Because no liquidating dividends have yet been recorded, $3,000 (10 percent × $30,000) is recorded as a reduction to the investment account in Year 3, and the remaining $4,500 is dividend revenue.

Significant Influence

A significant influence investment is an investment in the voting shares of a corporation that permits the investor to exercise significant influence over the strategic operating, financing, and investing policies of the investee; at the same time, however, it does not establish control or joint control over that investee. Note that the *Handbook*'s criteria for this type of investment require only the *ability* to exercise significant influence; there is no requirement to show that such influence is actually being exercised in a particular situation.

The following conditions are possible indicators that significant influence is present:

- The ability to elect members to the board of directors.
- The right to participate in the policymaking process.
- Significant intercompany transactions between the two companies.
- The size of ownership of the other shareholders of the investee.
- Exchanges of management and technology between the two companies.

Section 3050 suggests that a holding between 20 percent and 50 percent may indicate the presence of significant influence, but it also states that a holding of this size does not necessarily mean that such influence exists. The following scenarios will illustrate this.

Given that A Company owns 60 percent of the voting shares of C Company (probably a control investment), does B Company's holding of 30 percent of C Company's shares indicate that B Company has a significant influence investment? Not necessarily. If B Company is unable to obtain membership on the board of directors of C Company or participate in its strategic policymaking because of A Company's control, it would be difficult to justify calling B Company's holding a significant influence investment. In such a situation B Company's holding would be considered a portfolio investment. Would this situation be different if B Company were allowed membership on C Company's board of directors? Perhaps, based on the following:

> A substantial or majority ownership by another investor would not necessarily preclude an investor from exercising significant influence. [3050.04]

In other words, another company's control investment in C Company does not mean that B Company's 30 percent investment in C Company can never be considered to be significant influence. Determination of significant influence depends on the particular circumstances.

Furthermore, in the previous discussion on portfolio investments, an example was presented where an investment of less than 20 percent might qualify as a significant influence investment. From all these discussions and examples, it should be obvious that considerable professional judgment is required in distinguishing between portfolio and significant influence investments. In later chapters, when we discuss the criteria used to determine whether a particular investment establishes control over an investee, we will also conclude that professional judgment is required.

The *CICA Handbook* requires that significant influence investments be reported by the equity method. The basic concept behind the equity method is that the investor records its proportionate share of the investee's income as its own income and reduces the investment account by its share of investee dividends received.

Illustration of Equity Method Basics

We return to the example of the Jenstar and Safebuy companies. All the facts remain the same, including the 10 percent ownership, except that we assume this is a significant influence investment. Using the equity method, Jenstar's journal entries would be as follows:

Jan. 1, Year 1		
Investment in Safebuy	95,000	
Cash		95,000
To record the acquisition of 10% of Safebuy's shares		
Dec. 31, Year 1		
Investment in Safebuy	10,000	
Investment income		10,000
10% of Safebuy's Year 1 net income		
Cash	7,500	
Investment in Safebuy		7,500
Receipt of dividend from Safebuy		
Dec. 31, Year 2		
Investment in Safebuy	6,500	
Investment income		6,500
10% of Safebuy's Year 2 net income		
Cash	7,500	
Investment in Safebuy		7,500
Receipt of dividend from Safebuy		

Dec. 31, Year 3

Investment in Safebuy	3,000	
Investment income		3,000
10% of Safebuy's Year 3 net income		
Cash	7,500	
Investment in Safebuy		7,500
Receipt of dividend from Safebuy		

Under the equity method, the investor's investment account changes in direct relation to the changes taking place in the investee's equity accounts. The accounting objective is to reflect in the investor's financial statements the financial results arising from the close relationship between the companies. The equity method is effective at achieving this. Because the investor is able to influence the investee's dividend policy, dividends could end up being paid in periods during which the investee was suffering considerable losses. The cost method of reporting would reflect investment income, whereas the equity method would report investment losses during these periods.

The equity method reflects the accrual method of income measurement; the cost method does not. Even so, there have been some arguments made against the use of equity method reporting. In order to permanently finance growth, some companies retain some of their earnings by paying dividends in amounts that are less than yearly income. Other companies do not pay dividends at all for long periods of time. So while the accrual method of revenue recognition generally reflects cash flows that have already occurred, or are expected to occur soon, a portion (or all) of equity method income may never result in a cash inflow to the investor. This is because a portion of the investee's income has been allocated to permanent capital by management decision, or alternatively, will result in a cash flow only at some time in the distant future. The Canadian standard setters seem to have dismissed these arguments:

> In those situations in which the investor has the ability to exercise significant influence, shareholders ought to 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 income or losses of the investee. The equity method of accounting for the investment provides this information. [3050.11]

Additional Features Associated with the CICA Equity Method

The previous example illustrated the basic concepts of the equity method. Besides these fundamentals, three other major features referred to in the *Handbook* must be considered. These are the accounting for nonoperating income, intercompany profits, and considerations related to the investor's acquisition cost.

Investee Income from Nonoperating Sources The following extract outlines the accounting treatment in this situation:

> 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 should be disclosed in the investor's financial statements in accordance with their nature. [3050.09]

Companies report certain items separately on their income statements so that financial statement users can distinguish between the portion of net income that comes from continuing operations and the portion that comes from other sources, such as discontinued operations and extraordinary items. Retroactive restatements of prior period results and capital transactions are shown as separate components of retained earnings, or are disclosed in the footnotes. What the above paragraph is telling us is that because the equity method reflects the investor's share of changes in equity of the investee, the reader of the investor's statements should be provided with information to distinguish changes that came from the investee's continuing operations, from all other changes that occurred.

Example A Company owns 30 percent of B Company. The income statement of B Company for the current year is as follows:

B COMPANY
INCOME STATEMENT — CURRENT YEAR

Sales	$500,000
Operating expenses	200,000
Operating income before income tax	300,000
Income tax	120,000
Income from operations	180,000
Loss from discontinued operations (net of tax)	40,000
Income before extraordinary items	140,000
Extraordinary gain (net of tax)	10,000
Net income	$150,000

Upon receiving this income statement, A Company makes the following journal entry to apply the equity method:

Investment in B Company (30% × 150,000)	45,000	
Investment loss, discontinued operations*	12,000	
Investment gain, extraordinary item**		3,000
Investment income (30% × 180,000)		54,000

* 30% × 40,000
** 30% × 10,000

All three investment income items, which total $45,000, will appear on A Company's income statement. The investment loss from discontinued operations and the investment gain from extraordinary items require the same presentation as would be made if A Company had discontinued operations or extraordinary items of its own. Full footnote disclosure is required to indicate that these particular items arise from a significant influence investment accounted for by the equity method. Materiality has to be considered because these items do not require special treatment in A Company's income statement if they are not material from A Company's point of view, even though they *are* material from B Company's perspective.

Two other major features of equity method reporting as envisioned in the *Handbook* are captured in the following paragraphs:

> Investment income as calculated by the equity method should be that 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. [3050.08]

> Accounting for an investment under the equity method generally results in the net income of the investor being the same as the consolidated net income would have been if the financial statements of the investee had been consolidated with those of the investor. Depreciation and amortization of investee assets are based on the assigned costs of such assets at the date(s) of acquisition. The portion of the difference between the investor's cost and the amount of its underlying equity in the net assets of the investee that is similar to goodwill (equity method goodwill) is not amortized. No part of an impairment write-down of an investment accounted for by the equity method is presented in the income statement as a goodwill impairment loss (see Goodwill and Other Intangible Assets, Section 3062). Unrealized intercompany gain or loss and any gain or loss that would arise in accounting for intercompany bond holdings are eliminated. [3050.12]

Taken by themselves, these two paragraphs are difficult to interpret at this stage because of the reference made to the consolidation process. This material, which is covered in Section 1600, will be the main focus of the remaining chapters of this book. Discussed next are two major features of the consolidation process that have applications to the equity method of accounting for significant influence investments.

Acquisition Costs Greater Than Book Values In the previous examples we recorded Jenstar's investment at its cost, but we did not consider the implications of this cost with regard to Safebuy's book value at the time. We now add a new feature to equity method reporting by indeed paying attention to the book value of an investee's net assets.

Companies' shares often trade at prices that are different from their book values. There are many reasons for this, such as current economic conditions, anticipation of future profits, and the perceived worth of the company as a whole. It is this last reason that we will now focus on. Because it uses historical costs, a balance sheet does not reflect the worth of a company's assets. The asset values that do appear are often less than current values, and some assets do not appear at all. Stock market prices often reflect some of these differences. When an investor purchases an equity position in an investee that results in significant influence (or control or joint control), the cost to the investor has to be reflected when the investor's returns from the investment are measured. The logic behind this process can be captured in the following scenario.

An investor corporation that acquires all the revenue-earning assets of an investee will allocate the total acquisition cost to the assets purchased. In order to measure the returns from these assets, it will amortize their cost against the revenues they generate as part of the matching process. Suppose that instead of buying all of the assets, the investor buys all the common shares of the investee. Logic should direct us to the conclusion that if the price is identical, the net return should be identical.[6] The investor's return is its share (100 percent in this scenario) of the investee's yearly reported income. However, the investee's earnings are based on historical cost amortizations and allocations, which do not reflect the investor's acquisition cost. To properly measure the return from its common share investment, the investor has to adjust its share of the investee's yearly net income to take this acquisition cost into account. When the investment is less than 100 percent, as in the case of significant influence, the reasoning is similar.

[6] This assumes that the income tax effects of either scenario would be identical.

This process of properly measuring the investor's return from investment requires that we calculate, allocate, and amortize an item we call "the purchase discrepancy." This purchase discrepancy is calculated as the difference between the investor's cost and the investor's percentage of the book value of the investee's "identifiable" net assets. The investor allocates this discrepancy to specific assets[7] of the investee, and then amortizes the allocated components to reduce its income from the investment. The allocation is based on the investor's share of the difference between current fair values and carrying values as at the date of acquisition. The amortization is based on the estimated remaining lives of the specific assets.

Prior to June 30, 2001, any goodwill resulting from the allocation of the purchase discrepancy had to be amortized over its estimated useful life, which could not exceed 40 years. On this date the *Handbook*'s requirements were changed so that goodwill that is implicit from an investment accounted for by the equity method is no longer amortized, nor is it reviewed for impairment in the same manner as goodwill from a business combination. Instead, impairment of goodwill would be deemed to have happened if the market price of the shares had permanently declined below the investor's carrying value. The write-down of the investment would reduce the unamortized purchase discrepancy and would first be allocated to write down the goodwill until it was zero. After goodwill had been removed, any further write-down would be allocated to reduce the remaining unamortized purchase discrepancy.

Note that paragraph 3050.12, which was reproduced earlier, stated that impairment write-downs of significant influence investments are not presented separately on the income statement of the investor. Rather, they would be deducted to reduce the amount of the investment income from the investee that the investor company would otherwise report.

These new requirements will probably produce substantial differences in the amount of equity method income reported by an investor. While a significant influence investment allows an investor to have some say in the activities of the investee, it does not necessarily allow unlimited access to the investee's accounting records. Because the fair values of an investee's identifiable net assets are difficult for the investor to determine, a large portion of the purchase discrepancy is usually allocated to goodwill. Before the requirements were changed, the goodwill had to be amortized on a yearly basis, which reduced the amount reported by the investor as income from the investment. The new requirements do not require this yearly charge; thus, earnings from investment will be higher, and will only be reduced in years when an impairment loss occurs.

The following example will illustrate the allocation and amortization of the purchase discrepancy.

Example Hartley Inc. paid $40,000 to acquire 30 percent of the outstanding voting shares of Ivan Company. Ivan's net assets had a book value of $90,000 at the time, and specific plant assets were undervalued by $22,000 relative to current fair values. Hartley will determine the purchase discrepancy and its allocation by the following calculation:

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[7] The purchase discrepancy can also be allocated to liabilities. This concept will be examined in a later chapter.

Cost of 30% investment		$40,000
Book value of Ivan's net assets[8]	90,000	
Hartley's %	30%	27,000
Purchase discrepancy		13,000
Allocated:		
Undervalued plant assets 22,000 × 30%		6,600
Unallocated — goodwill		$ 6,400

The amount of the purchase discrepancy that cannot be allocated to specific identifiable assets of the investee is considered to be the intangible asset goodwill. In some situations this amount can be negative, but we will leave all discussions of this to later chapters. Hartley's journal entry to record its 30 percent investment is:

Investment in Ivan Company	40,000	
Cash		40,000

One year later, when Ivan reports a net income of $20,000, Hartley will make the following journal entry to take up its share of this income:

Investment in Ivan Company	6,000	
Investment income		6,000

In measuring this investment income on the basis of its acquisition cost, Hartley determines that the specific undervalued plant assets of Ivan have a remaining useful life of 6 years and decides that there has been no permanent decline in the market value of Ivan's shares.

The amortization of the purchase discrepancy is accomplished by the following journal entry:

Investment income	1,100	
Investment in Ivan Company		1,100

Amortization of the purchase discrepancy as follows:

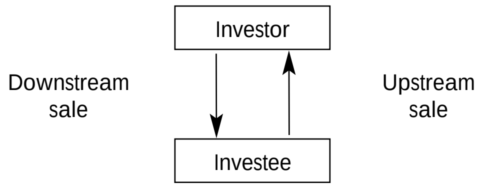
Plant assets 6,600 ÷ 6 years	=	$1,100
Goodwill	=	0
Total amortization		$1,100

Hartley's acquisition cost is now properly reflected in the $4,900 investment income, which appears as a separate item on its income statement.

Unrealized Profits As we will see in later chapters, consolidated financial statements are what you get when you combine the financial statement of a parent company with the financial statements of its subsidiaries. The end result is the financial reporting of a single economic entity, made up of a number of separate legal entities. One of the major tasks in this process is to eliminate all intercompany transactions — especially intercompany "profits" — so that the consolidated statements reflect only transactions with outsiders. The basic premise behind the elimination is that from the point of view of this single accounting entity, "you can't make a profit selling to yourself." Any such "unrealized profits" from intercompany transfers of inventory (or other assets) must be held back until the specific assets involved are sold to outside entities.

[8] Net assets are equal to total assets less total liabilities. Shareholders' equity also equals net assets. In making this type of calculation, it is often easier to use the amount for shareholder's equity rather than compute the amount for net assets.

In the case of a significant influence investment, any transactions between the investor and investee (they are related parties) must be scrutinized so that incomes are not overstated through the back-and-forth transfer of assets. From an accounting perspective, any transfer is acceptable provided that both parties record the transfer at the value that it is being carried at in the records of the selling company. However, if the transfer involves a profit, that profit must be held back on an after-tax basis in the investor's equity method journal entries. When the asset in question is sold outside or consumed by the purchaser, the after-tax profit is realized through an equity method journal entry, again made by the investor. The amount of before-tax profit being held back is the difference between cost and selling price, which in the case of inventory is the gross profit. The selling company pays tax on the profit, which means that it is the after-tax gross profit that is considered unrealized until it is confirmed by a sale to an outside entity. The final dollar amount used in the journal entry depends on whether the sale was "downstream" or "upstream." The following diagram illustrates the two streams:



In the two examples that follow we will illustrate the differences in the handling of the two streams of sales.

Example Harrison Corp. owns 35 percent of Gunn Inc. and uses the equity method to account for this significant influence investment. During Year 1, Harrison sold inventory to Gunn and recorded a 60 percent gross profit on the transaction. At the end of Year 1, the inventory of Gunn contained items purchased from Harrison for $75,000. Harrison pays income tax at a rate of 40 percent. The items of inventory in question were sold by Gunn to outsiders in Year 2. Note that the total amount of inventory sales that Harrison made to Gunn in Year 1 is not mentioned. This amount is not an issue in this particular context, although there will have to be full disclosure about such sales in the footnotes to Harrison's financial statements.[9] What is an issue is the amount of profit that is unrealized because it has not been sold to outsiders. The calculations required are as follows:

Items in Gunn's inventory	$75,000
Gross profit percentage	60%
Unrealized before-tax profit	45,000
Income tax (40%)	18,000
Unrealized after-tax profit	$27,000

Harrison's equity method journal entry to hold back the unrealized profit from this downstream sale at the end of Year 1 is:

Investment income	27,000	
Investment in Gunn Inc.		27,000
To hold back the after-tax unrealized profit on the sale of inventory to Gunn		

9 *CICA Handbook*, paragraph 3840.43.

The investment income that is being reduced here is Harrison's share of Gunn's Year 1 net income. This deferral remains in force until the inventory is sold outside, at which time the entry is reversed. In this case the inventory was sold in Year 2, so the entry that Harrison will make at that time to realize the profit is:

Investment in Gunn Inc.	27,000	
Investment income		27,000
To realize the after-tax profit that was held back in Year 1		

Another Example The previous example illustrated the handling of unrealized profits from downstream sales. In the present example, all of the facts (gross profit, tax rates, etc.) remain the same except that we assume an upstream sale in which Gunn sold the inventory to Harrison. The calculation changes slightly in this situation.

Items in Harrison's inventory	$75,000
Gross profit percentage	60%
Unrealized before-tax profit	45,000
Income tax (40%)	18,000
Unrealized after-tax profit	27,000
Harrison's ownership of Gunn	35%
Amount held back	$ 9,450

The amount of unrealized profit held back on an upstream sale is the investor's share of the profit that was recorded during the year by the investee. The investor takes up its share of the investee's net income for the year as a normal application of equity accounting, and then accounts for the fact that not all of this income was realized, because of an upstream sale of inventory.

Harrison's journal entry to hold back this unrealized profit at the end of Year 1 would be:

Investment income	9,450	
Investment in Gunn Inc.		9,450
To hold back the after-tax unrealized profit on Gunn's sale of inventory to Harrison		

At the end of Year 2, Harrison would make the following entry to realize the profit:

Investment in Gunn Inc.	9,450	
Investment income		9,450
To realize the after-tax profit that was held back in Year 1		

In the above illustrations of the holdback and realization of intercompany profits, the asset involved was inventory. The same basic concepts apply when assets other than inventory are sold in a similar manner. This topic will be discussed thoroughly in the consolidation chapters that follow.

Miscellaneous Considerations

The equity method as described in Section 3050 involves the investor recording its proportionate share of investee earnings from continuing operations adjusted for both the amortization of the purchase discrepancy and the holdback and realization of intercompany after-tax profits. Earnings from sources other than continuing operations are recorded separately. The following are some additional items that must also be considered.

Changes to and from the Equity Method The classification of long-term investments will change as the particular facts change. An investment may initially be portfolio and subsequently change to one of significant influence. This could transpire if additional shares were acquired. Once significant influence has been achieved, a switch from cost to equity methods is made on a prospective basis.[10] If there was more than one acquisition of shares, and it was the last one that gave significant influence, the investment cost used at the commencement of the equity method is the sum of the costs of the individual acquisitions. If circumstances change, significant influence may also be achieved without additional shares being acquired, in which case the equity method would commence. For example, the holdings of a large block of investee shares by another company could prevent an investor from exercising significant influence. But if that other company sells its block on the market, the investor's previous portfolio investment may now amount to significant influence.

When an investment changes from significant influence to portfolio, the equity method ceases to be appropriate and the cost method takes its place, also on a prospective basis. At this point the investment's carrying value, which was arrived at through the appropriate use of the equity method, becomes the new cost basis. The *Handbook* is unclear as to what to do with previously unrealized profits that were held back because of the related party status of the investor and investee. Logic would suggest that because the investor and investee are no longer related parties,[11] the investment account should be increased by the amounts that were previously held back.

When an investment changes from significant influence to control, the preparation of consolidated statements commences, again on a prospective basis. The concepts relating to this particular situation will be discussed at length in later chapters.

Loss in Value of Investment As previously mentioned, the carrying amount of a significant influence investment is reduced to market value if the decline is considered to be permanent. Evidence to support such permanence might include a prolonged period during which market was below carrying value, continued losses of the investee, suspension of trading in the investee, and serious going concern problems.

Losses Exceeding the Balance in the Investment Account A question arises as to the appropriate accounting when an investor's share of investee losses exceeds the carrying amount of the investment. There are two possible ways to treat this. The investor could reduce the investment account to zero and commence the use of the equity method when its share of investee earnings exceeds its share of losses. Alternatively, the investor could continue to accrue losses even though they result in a negative balance in the investment account. Section 3050 is silent on this issue, but the Emerging Issues Committee saw fit to address it with EIC-8. Their conclusion was that if the investor considers itself finished with the investee, it should not record losses past a zero balance in the investment account. However, if the investor has guaranteed the investee's obligations, or is committed to providing additional financial support, it would be appropriate to continue recording losses such that the balance in the investment account becomes negative. It is also appropriate to continue

[10] *Handbook*, Section 1506, "Accounting Changes," suggests that a switch from cost to equity is not considered a change in an accounting policy that would require retroactive accounting treatment (paragraph 1506.04).

[11] Paragraph 3840.03(g).

accruing investee losses if it appears that the investee is going to turn things around and become profitable at some future time. No mention is made of where to present this credit balance in the investor's balance sheet, but logically it should be shown under liabilities, and there should be full disclosure of the investor's commitments to the investee.

Gains and Losses on Sale of Investments When all the shares that make up a long-term investment are sold, the gain (loss) is shown on the income statement and is calculated as the difference between the sale proceeds and the carrying value of the investment. When only some of the shares are sold, the gain is calculated using the average carrying value of the investment. Cost flows such as FIFO or LIFO or specific identification are not permitted. If a portion of a significant influence or a control investment is sold, a re-evaluation must be made to determine whether the previous classification is still valid.

An International Perspective

The concept of accounting for a significant influence investment using the equity method is fairly common. Many countries, including the United States, the United Kingdom, France, Germany, Spain, and Australia, use the quantitative ownership guideline of 20 percent, and so does the IASB. Some countries, including Mexico, Chile, and Brazil, use a 10 percent guideline. All of the above countries as well as the IASC require the use of the equity method. China requires the cost method for this type of investment, while Switzerland and India allow either method. Presumably, countries would apply the equity method in the same manner that Canada does — by amortizing the purchase discrepancy and deferring unrealized intercompany profits — but differences in approach may exist. For example, U.S. accounting standards require that only the investor's share of downstream unrealized profits be eliminated, while GAAP in Canada requires the elimination of all of this profit. Canada and the United States appear to be the only countries that have abandoned the amortization of goodwill, replacing it with periodic write-downs based on impairment.

Many countries have the equivalent of Canada's "temporary" and "portfolio" investments, although terms such as *minority* and *passive* seem more common than the term *portfolio*. It is in the area of valuation that we begin to see some significant differences. China values all investments (other than control) at historical cost. Investments classified as current assets are valued at the lower of cost or market in the United Kingdom, France, Germany, Australia, and Chile. Mexico reports such investments at market, with unrealized gains (losses) reflected in income. The United States also values at market, but treats gains (losses) differently in accordance with their nature: those arising from securities trading are taken into income, while those from "available for sale" securities are reflected in a separate component of shareholders' equity. The IASB allows valuation either at the lower of cost or market, or at market, and allows the unrealized gains (losses) to be reflected either in income or as a separate component of shareholders' equity.

The accounting for investments classified as long term also shows some variation. The concept of historical cost, adjusted for permanent market declines, is followed in Germany and Japan. The lower of cost or market is used in Spain, Denmark, Chile, and India; while New Zealand, Australia, France, Switzerland, and the United Kingdom allow the use of either cost or current market value. The United

States, Mexico, and Denmark require valuation at market. There is variation among these countries as to the location (income statement or equity) of adjustments to market. Predictably, the IASB allows choices regarding which valuation method is used and how the resulting unrealized gains (losses) are presented.

SUMMARY

Three types of share investments were discussed in this chapter. Temporary investments are shown in current assets because the intention is to invest surplus cash in the short term. Income from this type of investment is recognized as dividends are received, which is basically the cost method. The main focus of the chapter was on two types of long-term investments.

Portfolio investments do not allow the investor any influence over the affairs of the investee and are accounted for using the cost method. If, however, the investment enables the investor to influence the operations of the investee, it is called a significant influence investment and must be accounted for using the equity method, as described in Section 3050 of the *Handbook*. This requires the investor to record its share of all increases in the shareholders' equity of the investee, adjusted for the amortization of the purchase discrepancy and the holdback and realization of upstream and downstream profits from the sale of assets.

SELF-STUDY PROBLEM

Part A On January 1, 2002, High Inc. purchased 10% of the outstanding common shares of Lowe Corp. for $75,000. Lowe's shareholders' equity had a book value of $700,000 on this date. From High's perspective, Lowe was a long-term investment; however, it did not give High significant influence.

On January 1, 2003, High purchased an additional 25% of Lowe's shares for $300,000. This second purchase allowed High to exert significant influence over Lowe. As of this date the plant and equipment of Lowe, which had an estimated remaining life of 5 years, were undervalued by $90,000, and its patents, which had an estimated remaining life of 7 years, were undervalued by $30,000.

During the two years, Lowe reported the following:

	Net income	*Dividends*
2002	$200,000	$120,000
2003	270,000	130,000

Additional Information

- During 2002, High transferred assets to Lowe and recorded a profit of $35,000 on the transaction.
- During 2003, Lowe sold inventory to High at a gross profit rate of 40%. At the end of 2003, High's inventory contained purchases made from Lowe amounting to $75,000. High sold this inventory to its unrelated customers in 2004.
- Assume tax rates of 40% for both companies for all of the years involved in this question.
- On December 31, 2004, a $6,000 permanent decline in the market value of the investment was recognized.

Required:

With respect to this investment, prepare High's journal entries for both 2002 and 2003.

Part B The following are summarized income statements for the two companies for 2004:

	High Inc.	*Lowe Corp.*
Revenues	$900,000	$600,000
Expenses (including income tax)	450,000	400,000
Income before extraordinary items	450,000	200,000
Extraordinary loss (net of tax)	—	20,000
Net income	*$450,000	$180,000

* The net income of High does not include any investment income from its investment in Lowe Corp.

Lowe paid no dividends in 2004.

Required:

(a) Prepare the journal entries that High should make at the end of 2004 with respect to its investment in Lowe.

(b) Prepare the income statement of High, taking into consideration the journal entries in part (a).

Solution to Self-study Problem

Part A The 10% purchase is a portfolio investment in 2002, accounted for under the cost method. Because of this, the intercompany asset transfer that occurs in 2002 is considered to be between unrelated parties, which means that there are no unrealized profits as a result of the transaction. High's journal entries during 2002 are:

Investment in Lowe	75,000	
Cash		75,000
Purchase of 10% of shares of Lowe		
Cash	12,000	
Dividend revenue		12,000
10% × 120,000		

The 25% purchase in 2003 changes the investment to one of significant influence, which is accounted for prospectively. The following calculation is made as of this date:

Cost of 10%		$ 75,000
Cost of 25%		300,000
Total cost of significant influence investment		375,000
Book value of Lowe:		
On Jan. 1, 2002	700,000	
Net income 2002	200,000	
Dividends	(120,000)	
	780,000	
	35%	273,000
Purchase discrepancy		102,000
Allocated:		
Plant and equipment — 90,000 × 35%	31,500	
Patents — 30,000 × 35%	10,500	42,000
Balance — goodwill		$ 60,000

The yearly purchase discrepancy amortization during the next five years will be:

Plant and equipment	31,500 ÷ 5 years =	$ 6,300
Patents	10,500 ÷ 7 years =	1,500
		$ 7,800

Because this is now a significant influence investment, 2003 intercompany upstream sales are between related parties, and any unrealized profits at the end of the year must be deferred. The calculation is as follows:

Items in High's inventory	$75,000
Gross profit percentage	40%
Unrealized before-tax profit	30,000
Income tax (40%)	12,000
Unrealized after-tax profit	18,000
High's ownership of Lowe	35%
Amount held back	$ 6,300

The journal entries that High makes in 2003 are as follows:

Investment in Lowe	300,000	
Cash		300,000
Purchase of 25% of shares of Lowe		
Investment in Lowe	94,500	
Investment income		94,500
35% × 270,000 net income		
Cash	45,500	
Investment in Lowe		45,500
35% × 130,000 dividends		
Investment income	7,800	
Investment in Lowe		7,800
Amortization of purchase discrepancy		
Investment income	6,300	
Investment in Lowe		6,300
To hold back unrealized profit on upstream sale of inventory		

Part B (a) Applying the CICA equity method, High makes the following journal entries in 2004:

Investment in Lowe*	63,000	
Investment loss extraordinary**	7,000	
Investment income***		70,000

* 35% × 180,000
** 35% × 20,000
*** 35% × 200,000

Investment income	7,800	
Investment in Lowe		7,800
Amortization of purchase discrepancy		
Investment in Lowe	6,300	
Investment income		6,300
To realize profit on upstream sale of inventory held back in 2003		
Investment income	6,000	
Investment in Lowe		6,000
To recognize a goodwill impairment loss		

(b) Investment income — 2004

Share of ordinary net income	$70,000
Realization of profit on upstream sales	6,300
Purchase discrepancy amortization & goodwill impairment loss	(13,800)
	$62,500

HIGH INC.
INCOME STATEMENT
(year ended December 31, 2004)

Operating revenue	$900,000
Expenses (incl. income tax)	450,000
Income from operations	450,000
Investment income*	62,500
Income before extraordinary items	512,500
Investment loss — extraordinary (net of tax)*	7,000
Net income	$505,500

* A footnote would disclose that these items came from a 35% investment in Lowe, accounted for using the equity method.

APPENDIX

A Listing of Emerging Issue Abstracts

Number	*Topic*	*Related Handbook Section*
EIC–3	Mid-term Hedging of a Long-term Foreign Currency Denominated Monetary Item	1650
EIC–8	Recognition of an Equity Accounted Investee's Losses in Excess of the Investment	3050
EIC–10	Reverse Takeover Accounting	1581
EIC–11	Changes in Reporting Currency	1650
EIC–12	Capitalization of Interest Costs on Investments in Potential Takeover Targets	1581
EIC–14	Adjustments to the Purchase Equation Subsequent to the Acquisition Date	1581, 1600
EIC–16	Short-term Foreign Currency Obligations Under Long-term Debt Facilities	1650
EIC–17	Deferral and Amortization of Foreign Exchange Gains and Losses on Debt with Contractual Terms That Differ from the Intended Repayment Period	1650
EIC–26	Reductions in the Net Investment of Self-sustaining Foreign Operations	1650
EIC–35	Accounting for Discontinued Operations Subsequently Retained	3475
EIC–38	Accounting for Newly Formed Joint Ventures	3055
EIC–42	Costs Incurred in Business Combinations	1581
EIC–45	Discontinued Operations	3475
EIC–55	Identifiable Assets Acquired in a Business Combination	1581
EIC–62	Measurement of Cost of a Business Acquisition Effected by Issuing Shares	1581
EIC–63	Income Statement Presentation of Results of a Portion of a Business Segment Held for Disposal	3475
EIC–64	Goodwill Disclosures	1600, 3062

EIC–66	Transfer of a Business Between Entities Under Common Control	1581
EIC–73	Buy-out Transactions	1581
EIC–75	Scope of CICA 3860 — Interests in Subsidiaries Presented in Non-consolidated Financial Statements	3050
EIC–81	Non-monetary Transactions in Which the Transferor Receives an Equity Interest in the Transferee	1590, 3050, 3055
EIC–89	Exchanges of Ownership Interests Between Entities Under Common Control — Wholly and Partially-Owned Subsidiaries	1581, 1600
EIC–90	Future Income Tax Assets and Liabilities of an Integrated Foreign Operation — Accounting for Unrealized Translation Gains and Losses	1650, 3465
EIC–92	Arms-Length Buy-Out of a Business Followed by an Amalgamation	1581, 1600
EIC–99	Future Income Taxes in Business Combinations That Do Not Involve the Recognition of Goodwill as an Intangible Asset Presented Separately on the Balance Sheet	1581, 3465, 3062
EIC–106	Application of CICA 3465 to Investments Accounted for by the Equity Method	3050
EIC–110	Accounting for Acquired Future Tax Benefits in Certain Purchase Transactions	1581
EIC–115	Segment Disclosure — Application of the Aggregation Criteria in CICA 1701	1701
EIC–119	The Date of Acquisition of a Business Combination	1581, 1590, 1600
EIC–120	CICA 3465 — Future Income Taxes Related to Intangible Assets Acquired in a Business Combination	1581, 3062

REVIEW QUESTIONS

1. Business combinations and the preparation of consolidated financial statements are really only a subset of a "big picture." In one sentence, describe the big picture.
2. How is the concept of a business combination related to the concept of a parent–subsidiary relationship?
3. What is the purpose of the Emerging Issues Committee? Are the abstracts issued by this committee considered to be GAAP in Canada?
4. Distinguish between the financial reporting for portfolio investments and that for significant influence investments.
5. What is the difference between a "control" investment and a "joint control" investment?
6. What event is necessary before a Canadian company is permitted to revalue all its assets and liabilities?
7. What is the purpose of the *Handbook* section on segment disclosures?
8. What criteria would be used to determine whether the equity method should be used to account for a particular investment?
9. The equity method records dividends as a reduction in the investment account. Explain why.
10. What factors would be used as evidence that an investor had obtained significant influence over an investee?

11. The Ralston Company owns 35% of the outstanding voting shares of Purina Inc. Under what circumstances would Ralston determine that it is inappropriate to report this investment in its financial statements using the equity method?
12. Even though the equity method is considered to be part of GAAP, some theoretical arguments have been made against it. Explain what they are.
13. An investor uses the equity method to report its investment in an investee. During the current year the investee reports an extraordinary gain on its income statement. How should this item be reflected in the investor's financial statements?
14. Ashton Inc. acquired a 40% interest in Villa Corp. at a bargain price that was substantially below book value, because Villa had suffered significant losses in past years. Ashton's cost was $200,000. In the first year after acquisition, Villa reported a loss of $700,000. Using the equity method, how should Ashton account for this loss?
15. Under the equity method, a portion of an investor's purchase price is assigned either to specific assets of the investee or to goodwill. How is this done? Why is it done?
16. Able Company holds a 40% interest in Baker Corp. During the year, Able sold a portion of this investment. How should this investment be reported after the sale?
17. What differentiates a downstream sale from an upstream sale? Are the equity method journal entries the same for each?

MULTIPLE CHOICE

1. Which one of the following accounting methods is recommended by *Handbook* Section 3010 for reporting temporary investments?
   a. Portfolio method.
   b. Lower of cost or market method.
   c. Equity method.
   d. Consolidation.
2. Which one of the following would not be a factor to consider when determining whether an investment results in significant influence?
   a. Whether the investor held a position on the investee's board of directors.
   b. Whether the investor purchased a significant amount of the investee's production output.
   c. Whether the investor and the investee operated in the same country.
   d. Whether the investor and the investee exchanged technical expertise.
3. Perez Inc. owns 25% of Senior Ltd. During 2002, Perez sold goods with a 40% gross profit to Senior. Senior sold all of these goods in 2002. How should Perez report the effect of the intercompany sale on its 2002 income statement?
   a. Sales and cost of goods sold should be reduced by the amount of the intercompany sales.
   b. Sales and cost of goods sold should be reduced by 25% of the amount of the intercompany sales.
   c. Investment income should be reduced by 25% of the gross profit on the intercompany sales.
   d. No adjustment is necessary.

4. When an investor uses the equity method to account for investments in common stock, how should cash dividends received by the investor from the investee be recorded?
   a. a deduction from the investor's share of investee profits.
   b. dividend income.
   c. a deduction from the shareholders' equity account dividend to shareholders.
   d. as a deduction from the investment account.
5. Which of the following is not an indication that an investor company has the ability to significantly influence an investee?
   a. Material intercompany transactions.
   b. The investor company owns 30% of the investee company but another owner holds the remaining 70%.
   c. Interchange of personnel.
   d. Technological dependency.
6. On January 1, 2000, X Company acquired 20% of Y Company for $4,000,000. On the acquisition date Y Company had common shares of $5,000,000 and retained earnings of $10,000,000. The only purchase price discrepancy adjustment is the annual amortization of the purchase discrepancy of $100,000 (X's portion). From January 1, 2000, to December 31, 2002, Y Company earned net income of $3,000,000 and paid dividends of $1,000,000. What would be the balance in the Investment in Y Company account in the accounting records of X Company on December 31, 2002?
   a. Assuming X Company uses the cost method, $4,100,000.
   b. Assuming X Company uses the cost method, $4,300,000.
   c. Assuming X Company uses the equity method, $4,100,000.
   d. Assuming X Company uses the equity method, $4,400,000.

   (*CGA adapted*)
7. How should an investment be accounted for where the investor exercises significant influence over the investee?
   a. At cost plus the parent's share of the subsidiary's change in retained earnings since the date of acquisition.
   b. At cost plus the parent's share of the subsidiary's net income, adjusted annually through retained earnings.
   c. At market value with changes in market value adjusted through income.
   d. At market value with changes in market value adjusted through retained earnings.

   (*CGA adapted*)

Use the Following Data for Questions 8 and 9.

AB Company purchased 25% of the shares of KC Corporation on July 1, 2002, for $100,000, which allows it to exercise significant influence. Both companies had December 31, 2002 year-ends. During 2002, KC had a net income of $120,000 ($10,000/month) and paid dividends of $80,000 ($20,000 every 3 months, on the last day of each fiscal quarter).

8. As at December 31, 2002, how much would AB's investment in KC be on AB's balance sheet?
   a. $100,000
   b. $105,000
   c. $110,000
   d. $120,000

9. Assuming that AB's 25% investment in KC did not allow it to exercise significant influence, how much income would AB report from its investment in KC for the year ended December 31, 2002?
   a. $10,000
   b. $20,000
   c. $30,000
   d. $40,000

10. RU Ltd. has invested in several domestic manufacturing corporations. Which of the following investments would most likely be accounted for under the equity method on the consolidated financial statements of RU?
    a. A holding of 2,000 of the 50,000 outstanding common shares of SU.
    b. A holding of 3,000 of the 10,000 outstanding preferred shares of TU.
    c. A holding of 15,000 of the 60,000 outstanding common shares of XU.
    d. A holding of 20,000 of the 25,000 outstanding common shares of VU.

    (*CGA adapted*)

11. On January 1, 2002, Top Company purchased a 10% interest in the common shares of Bottom Ltd. for $50,000. Bottom reported net incomes and paid dividends as follows:

    2002 — net income $60,000; dividends paid $80,000.

    2003 — net income $105,000; dividends paid $80,000.

    Assume that Top uses the cost method to account for its investment in Bottom. Which of the following is the amount that a balance sheet for Top would report as "Investment in Bottom" at December 31, 2003?
    a. $48,000
    b. $49,500
    c. $50,000
    d. $50,500
    e. none of the above.

12. Pipe Ltd. acquired a 30% interest in the common shares of Tobacco Ltd. on January 1, 2002. The purchase difference of $10,000 was identified and allocated entirely to patents, which were estimated to have a 10-year useful life. During 2002, Tobacco sold merchandise to Pipe at 50% gross profit. At December 31, 2002, Pipe's inventory includes merchandise from Tobacco purchased by Pipe for $4,800. For 2002, Tobacco reported net income of $70,000 and paid dividends of $20,000. Both companies are subject to 40% tax rates.

    If Pipe uses the equity method to account for its investment in Tobacco, how much investment income will it report in 2002?
    a. $18,560
    b. $19,568
    c. $20,000
    d. $21,000

Use the Following Data for Questions 13 and 14.

On January 1, 2002, Xanadu Co. purchased a 20% interest in Zap Inc. for $4,000,000. In 2002, Zap reported net income from operations of $525,000 and an extraordinary gain of $83,000 (net of tax). Zap declared and paid dividends of $90,000 on December 31, 2002.

13. Assume the above is a portfolio investment. Which of the following is the amount that would be reported on Xanadu's 2002 income statement relating to Zap?

a. Investment income of $116,600.
b. Dividend revenue of $90,000.
c. Investment income of $105,000 and investment gain extraordinary item of $16,600.
d. Dividend revenue of $18,000.

14. Assume the above is a significantly influenced investment. Which of the following is the amount that would be reported on Xanadu's 2002 income statement relating to Zap?
   a. Investment income of $121,600 and investment gain extraordinary item of $16,600.
   b. Investment income of $121,600.
   c. Investment income of $105,000 and investment gain extraordinary item of $16,600.
   d. Dividend revenue of $18,000.

Use the Following Data for Questions 15 to 17.

On January 1, 2002, Bean Co. purchased a 30% interest in Dod Co. for $250,000. On this date, Dod's shareholders' equity was $500,000. The carrying value of Dod's identifiable net assets was equal to book values, except for equipment, which was undervalued by $50,000. This equipment had an estimated remaining useful life of 10 years. Dod reported net income of $100,000 for 2002 and paid dividends of $20,000. Bean correctly reports this significant influence investment using the equity method. Both companies have a December 31 year-end.

During 2003, Dod sold merchandise it had purchased for $60,000 to Bean for $100,000. At the end of 2003, Bean held 50% of this merchandise in its inventory. Both companies are taxed at 40%. For the year ended December 31, 2003, Dod reported net income of $150,000 and paid dividends of $40,000. On December 31, 2003, Bean recorded a permanent decline in the market value of its investment amounting to $4,250.

15. Which of the following is the amount that Bean would report as its investment in Dod at December 31, 2002?
   a. $275,500
   b. $272,500
   c. $274,000
   d. $278,750

16. Which of the following is the amount that represents the adjustment required to the investment income in 2003 for unrealized profit (after tax)?
   a. $3,600
   b. $6,000
   c. $8,000
   d. $12,000

17. Which of the following is the amount that would be reported for investment income on Bean's 2003 financial statements?
   a. $45,000
   b. $35,650
   c. $41,400
   d. $27,600

18. INV owns 10% of the shares of PLA Inc. For five years now, PLA has been paying a regular dividend at the end of its fiscal year. PLA's year-end is December 31, while INV's is September 30. When should the dividend be recognized as revenue in INV's books?
    a. On September 30, since there is reasonable certainty that it will be paid.
    b. On the day on which INV receives the cheque.
    c. On the day on which PLA's board of directors adopts a resolution declaring a dividend.
    d. On the day that PL mails the cheque, the postmark providing proof.

(*CGA adapted*)

19. Price Co. has gradually been acquiring shares of Berry Co. and now owns 37% of the outstanding voting common shares. The remaining 63% of the shares are held by members of the family of the company founder. To date, the family has elected all members of the board of directors, and Price Co. has not been able to obtain a seat on the board. Price is hoping eventually to buy a block of shares from an elderly family member and thus one day own 60%.

    How should the investment in Berry Co. be reported in the financial statements of Price Co.?
    a. Consolidation.
    b. Cost method.
    c. Equity method.
    d. Market value.

(*CGA adapted*)

20. PCI is a distributor of maintenance equipment. Early in 2002, PCI acquired 165,000 voting shares of Duracom (a 25% voting interest) for a total consideration of $165,000. PCI is one of Duracom's major customers. PCI invested in Duracom to ensure a degree of stability in the price and quality of its supplies. In 2002 and 2003, Duracom earned a net income of $60,000 and $80,000 respectively, and declared annual dividends of $40,000 to holders of voting shares. On December 31, 2003, the fair market value of Duracom's shares was $0.90 per share. On March 15, 2004, when PCI's financial statements were finalized, Duracom shares were trading at $1.10.

    How should PCI record its investment in Duracom in its balance sheet as at December 31, 2003?
    a. At $148,500, with the $165,000 cost of the purchase presented as additional information.
    b. At $165,000, with the fair market value of the shares presented as additional information.
    c. At $180,000, with no additional information presented about fair market value.
    d. At $181,500, with the $165,000 cost of the purchase presented as additional information.

(*CGA adapted*)

CASES

Case 1 Floyd's Specialty Foods Inc. (FSFI) operates over 60 shops throughout Ontario. The company was founded by George Floyd when he opened a single shop in the city of Cornwall. This store sold prepared dinners and directed its products at customers who were too busy to prepare meals after a long day at work. The concept proved to be very successful and more stores were opened in Cornwall. Recently new stores were opened in five other Ontario cities. Up to the current year, the shares of FSFI have been owned entirely by Floyd. However during this year, the company suffered severe cash flow problems, due to too-rapid expansion exacerbated by a major decline in economic activity. Profitability suffered and creditors threatened to take legal action for long-overdue accounts. To avoid bankruptcy, Floyd sought additional financing from his old friend James Connelly, who is a majority shareholder of Cornwall Autobody Inc. (CAI). Subsequently, CAI paid $950,000 cash to FSFI to acquire enough newly issued shares of common stock for a one-third interest.

At the end of this year, CAI's accountants are discussing how they should properly report this investment in the company's financial statements.

One argues for maintaining the asset at original cost, saying, "What we have done is to advance money to bail out these stores. Floyd will continue to run the organization with little or no attention to us, so in effect we have loaned him money. After all, what does anyone in our company know about the specialty food business? My guess is that as soon as the stores become solvent, Floyd will want to buy back our shares."

Another accountant disagrees, stating that the equity method is appropriate. "I realize that our company is not capable of running a specialty food company. But the rules state that ownership of over 20% is evidence of significant influence."

A third accountant supports equity method reporting for a different reason. "If the investment gives us the ability to exert significant influence, that is all that is required. We don't have to actually exert it. One-third of the common shares certainly gives us that ability."

Required:

How should Cornwall Autobody Inc. account for its investment? Your answer should include a discussion of all three accountants' positions.

Case 2

Magno Industries Ltd. is a major supplier to the automotive replacement parts market, selling parts to nearly every segment of the industry. Magno has a September 30 year-end.

During January 2002, Magno acquired a 13% interest in the common stock of Grille-to-Bumper Automotive Stores and in June 2002 it acquired an additional 15 percent. Grille-to-Bumper is a retail chain of company-owned automotive replacement part stores operating in most Canadian provinces. Its shares trade on the Canadian Venture Exchange. Grille-to-Bumper has a December 31 year-end and, despite being profitable each year for the last 10 years, has never paid a dividend. While Magno occasionally makes sales to Grille-to-Bumper, it has never been one of its major suppliers.

After the second acquisition of Grille-to-Bumper's shares, Magno Industries contacted Grille-to-Bumper to obtain certain financial information and to discuss mutual timing problems with respect to financial reporting. In the initial contact, Magno found Grille-to-Bumper to be unco-operative. In addition, Grille-to-Bumper accused Magno of attempting to take it over. Magno replied that it had no intention of attempting to gain control, but rather was only interested in making a sound long-term investment. Grille-to-Bumper was not impressed with this explanation and refused to have any further discussions regarding future information exchanges and the problems created by a difference in year-ends.

At the year-end of September 30, 2002, Magno's management expressed a desire to use the equity method to account for its investment. On that date, the market value of its investment in Grille-to-Bumper common stock had declined by 8.5% over its acquisition cost.

Required:

1. What method of accounting would you recommend Magno Industries use for its investment in Grille-to-Bumper Automotive common stock? As part of your answer, discuss the alternatives available.
2. Why would the management of Magno want to use the equity method to account for the investment, as compared to other alternatives that you have discussed?
3. Are there any circumstances under which the method you have recommended might have to be changed? If so, how would Magno Industries account for such a change?

PROBLEMS

Problem 1 On January 1, 2002, Anderson Corporation paid $750,000 for 20% of the outstanding shares of Carter Inc. The investment was considered to be significant influence. The balance sheet of Carter showed net assets of $3,000,000 on this date. Any purchase discrepancy was allocated to equipment with a remaining life of 10 years. In 2002, Carter reported earnings of $95,000; in 2003 its earnings were $105,000. Dividends paid were $50,000 in each of the two years.

Required:

Calculate the balance in Anderson's investment account as at December 31, 2003.

Problem 2 Baskin's purchased 40% of Robbin's on January 1, 2002, at a cost of $550,000. This was considered to be significant influence. Robbin's balance sheet reported assets of $1,500,000 and liabilities of $600,000 on that date. A building with an estimated remaining life of 8 years is undervalued by $160,000 on Robbin's balance sheet. At the end of 2002, Robbin's reported a net income of $85,000 and declared dividends of $32,000. Baskin's wrote down its investment by $6,300 on December 31, 2002.

Required:

Calculate the balance in Baskin's investment account as at December 31, 2002.

Problem 3 Pender Corp. owns 30% of Saltspring Inc. On the last day of the current year, Saltspring buys inventory at a cost of $75,000 and sells it to Pender for $100,000 cash. Pender is still holding this inventory. Assume a 40% tax rate.

Required:

Prepare the journal entry relating to this transaction that Pender should make at the end of the current year, assuming that this is:

(a) a portfolio investment.
(b) a significant influence investment.

Problem 4 On January 1, 2002, Warner Corporation purchased 30% of the outstanding common shares of Rexdale Limited for $1,250,000. On that date the net assets of Rexdale had a book value of $4,000,000, and all of the individual assets of Rexdale had fair values that were equal to their book values except for:

	Fair value	*Book value*
Buildings (remaining life 10 years)	$890,000	$820,000

The following relates to Rexdale since the acquisition date:

Year	*Net income*	*Dividends paid*
2002	$ 35,000	$50,000
2003	100,000	50,000

Required:

(a) Assume that the number of shares held by Warner is enough to give it significant influence over Rexdale. Prepare all the journal entries that Warner should make regarding this investment in 2002 and 2003.

(b) Assume that Warner does *not* have significant influence. Prepare all the journal entries that Warner should make regarding this investment in 2002 and 2003.

Problem 5 Poole Corp. owns 45% of Campbell Company, which enables it to exercise significant influence over that company. During the current year the companies sold merchandise to each other. At the end of the current year a portion of this merchandise remained in the inventory of both companies.

Required:

(a) How is the amount of unrealized profit calculated?

(b) What is the distinction between an upstream transfer and a downstream transfer?

(c) Does the direction (upstream or downstream) affect the amount of profit held back?

(d) Explain how Poole would calculate the amount of investment income to recognize this year.

(e) Explain how Poole would calculate the amount of investment income next year.

(f) Suppose that none of the merchandise transferred between the two companies remained in inventory at the end of the current year, but each company recorded a substantial profit in its sales to the other company. Would the fact that these transfers were made during the year affect how the equity method was applied?

(g) How would these intercompany transfers affect the financial reporting in the current year by Campbell?

Problem 6 On January 1, Year 1, Investor Ltd. made an open market purchase representing 25% of the outstanding shares of Investee Corp. The cost of the investment was $195,000, and the shareholders' equity of Investee amounted to $510,000 on this date. Investor plans to treat any difference between the investment's cost and the proportionate share of the shareholders' equity of Investee as equipment to be amortized on a straight-line basis over 5 years.

Investee has a December 31 year-end. Its income statements for the next two years showed the following:

	Year 1	*Year 2*
Net income (loss) before extraordinary items	$300,000	$(50,000)
Extraordinary gain (net of tax)	45,000	—
Net income (loss)	$345,000	$(50,000)

On December 31 in each of years 1 and 2, Investee paid dividends of $90,000.

Required:

(a) Prepare Investor's journal entries in each of the two years, assuming that this is a significant influence investment.

(b) Prepare Investor's journal entries in each of the two years, assuming that this is a portfolio investment.

Problem 7 On January 1, 2002, Donatello Inc. acquired 30% of the outstanding voting shares of Nestell Corp. for $400,000. The balance sheet of Nestell and the fair market value of its assets and liabilities on this date were as follows:

		Fair value
Accounts receivable	$ 200,000	$200,000
Inventory	300,000	300,000
Plant assets (net)	800,000	860,000
	$1,300,000	
Liabilities	$ 100,000	100,000
Common shares	700,000	
Retained earnings	500,000	
	$1,300,000	

Nestell's plant assets had a remaining life of 10 years on this date.

The following are the income statements of the two companies as at December 31, 2002.

	Donatello	*Nestell*
Sales	$900,000	$700,000
Operating expenses (including tax)	600,000	500,000
Net income from continuing operations	300,000	200,000
Extraordinary gain (loss)(net of tax)	25,000	(80,000)
Net income	$325,000	$120,000

On December 31, 2002, Donatello received a dividend from Nestell amounting to $50,000. Because the company's accountant was not certain how to properly record it, an account called "suspense" was credited with $50,000. A permanent decline in the market value of the investment of $1,100 was also recorded.

Required:

PART A

Assume that this is a significant influence investment requiring the equity method of accounting.

(a) Prepare all the journal entries with regard to this investment that Donatello Inc. would be required to make in 2002.

(b) Prepare a summarized income statement for Donatello, taking into account the journal entries in (a) above.

PART B

Assume that this is a portfolio investment requiring the cost method of accounting.

(a) Prepare all the journal entries with regard to this investment that Donatello would be required to make in 2002.

(b) Prepare a summarized income statement for Donatello taking into account the journal entries in (a) above.

Problem 8 Crown Inc. owns 35% of the shares of Jewel Corp. and has the ability to significantly influence the operations and decision making of that company. On January 1, 2002, the balance in the investment in Jewel account was $340,000. Amortization associated with the investment was $12,000 per year. On December 31, 2002, Jewel reported earnings of $85,000 and declared dividends of $20,000. In 2001, Jewel had sold inventory costing $24,000 to Crown for $40,000. This merchandise was still on hand in Crown's inventory at December 31, 2001, and was finally sold to Crown's outside customers in 2002. During 2002, Crown sold inventory to Jewel and recorded a profit of $50,000 on the transaction. On December 31, 2002, 30% of this inventory was still on hand. Assume a 40% tax rate.

The following summarized income statement was prepared by the accountant for Crown Inc. before any equity method journal entries were prepared with respect to the investment in Jewel.

CROWN INC.
INCOME STATEMENT — 2002

Sales	$997,000
Operating expenses (including income tax)	625,000
Net income	$372,000

Required:

(a) Prepare a summarized income statement for Crown after the investment in Jewel has been accounted for in accordance with GAAP.
(b) What is the balance in the investment account at the end of 2002?

Problem 9

On January 1, Year 1, Parkade Company purchased, for $89,000, 35% of the outstanding voting shares of Summit Company. The following is Summit's balance sheet at that date:

	Book value
Cash	$ 20,000
Accounts receivable	30,000
Equipment (net)	80,000
	$130,000
Accounts payable	$ 10,000
Common stock	20,000
Retained earnings	100,000
	$130,000

Book values were equal to fair values except for equipment, which had a net fair value of $100,000. Summit is depreciating the equipment on a straight-line basis, and the remaining life is 7 years. The original salvage value was $10,000. Summit reported profits and paid dividends as follows:

	Profits	*Dividends*
Year 1	$10,000	$ 5,000
Year 2	15,000	15,000
Year 3	20,000	30,000

Required:

(a) Calculate the amount of goodwill at the date of acquisition of this investment.
(b) Calculate the balance in Parkade Company's investment account at the end of Year 3 if the equity method is used.
(c) Calculate the balance in this account if the cost method is used.

(*CGA adapted*)