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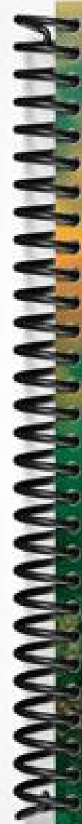

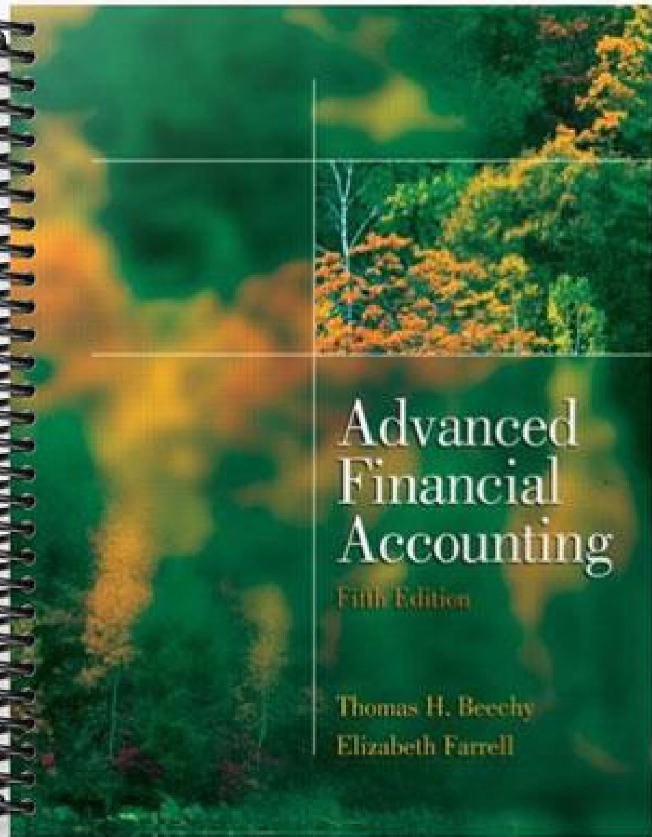

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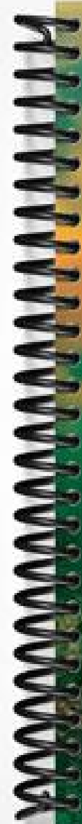

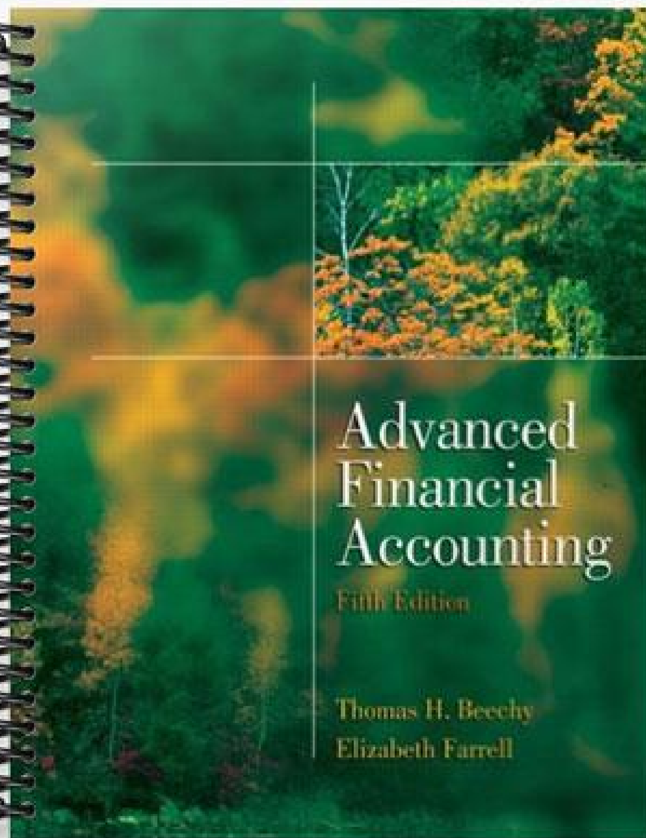

CHAPTER 2

Intercorporate Investments: An Introduction

This chapter reviews the accounting for intercorporate investments. Discussion of a portfolio investment, a joint venture, an investment subject to significant influence, a controlled investment and a variable interest entity is included as well as the appropriate method of accounting for each. Differential reporting, as it applies to accounting for investments, is also discussed. The chapter concentrates on investments which are controlled or subject to significant influence.

The concepts of control and significant influence (both direct and indirect) are discussed from both a qualitative and a quantitative perspective. A simple example of a wholly-owned parent founded subsidiary is used to illustrate consolidation and equity reporting, and to draw the distinction between the reporting and recording of intercorporate investments. Two approaches are used to illustrate the consolidation process: the direct and the worksheet approach. This will allow students to experiment with both approaches to determine which one works best for them. The usefulness and shortcomings of consolidation and equity reporting are discussed, as are the conditions under which nonconsolidated statements may be useful.

SUMMARY OF ASSIGNMENT MATERIAL

Case 2-1
Two short examples of investments are described. The student must determine the appropriate method of accounting for these investments.

Case 2-2
An investor corporation has varying ownership interests in several other companies. Students are asked which basis of reporting is appropriate based on the nature of the relationships between the investor and the investees, and also which subsidiaries should be consolidated. This case is useful for reviewing the substance of significant influence and for reviewing the criteria for consolidation as described in Section 1590.

Case 2-3
A business combination has occurred but has the new investor acquired control? This is the central issue in this case where the new investor has purchased all the Class A voting shares but the Class B voting shares are held by another party. The shareholder agreement is also relevant.

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Case 2-4
This is a multi-competency case with coverage of both accounting and assurance issues. The majority of the issues in the case relate to the appropriate accounting method for a series of investments. If desired, the instructor could request that the students focus on the accounting issues only.

P2-1 (15 minutes, easy)
An investment scenario is provided and students are asked to identify when each of proportionate consolidation, the equity method and consolidation would be appropriate, with explanations.

P2-2 (10 minutes, easy)
A simple problem which focuses on the differences between the cost and equity methods of accounting for investments.

P2-3 (10 minutes, easy)
A simple problem on the application of the equity method to a parent-founded subsidiary. No adjustments are necessary.

P2-4 (20 minutes, easy)
A straightforward consolidation of a parent-founded subsidiary several years after its establishment. Only a balance sheet is required.

P2-5 (30 minutes, medium)
A consolidated income statement for a parent-founded subsidiary is required. Three eliminations must be made. The investment is carried at cost on the parent’s books.

P2-6 (30 minutes, medium)
Consolidation of a parent-founded subsidiary when the investment account is carried at equity. Both an income statement and a balance sheet are required. A number of eliminations must be made.

P2-7 (20 minutes, medium)
Consolidation of a parent-founded subsidiary when the investment account is carried on the equity basis. Two eliminations must be made. There are goods in inventory that were sold from one company to the other but, since the sales were at cost, there is no unrealized profit. This problem could be used to introduce the treatment of inventories arising from intercompany transactions. Both a balance sheet and an income statement are required.

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ANSWERS TO REVIEW QUESTIONS

2-1:

a. An intercorporate investment is any investment by one corporation in the debt or securities of another corporation, which is generally in common or preferred shares or bonds.

b. A subsidiary is a corporation that is controlled by another corporation, its parent corporation. Normally, control is achieved by owning a majority of the subsidiary corporation's voting shares, but under certain circumstances, control can also be achieved with less than an immediate and absolute majority of the votes. For example, a shareholders' agreement gives control to a shareholder who owns 50% or less of shares, or convertible securities or stock options which, if converted, would give majority of votes.

c. Significant influence is the ability of one corporation to have a substantial impact on the strategic operating, investing and financing policies of another corporation.

d. Control is the continuing ability to determine an enterprise's strategic operating, investing and financing policies *without the cooperation of others*.

e. Indirect control exists when a subsidiary of a parent corporation has a subsidiary of its own. The parent then has indirect control of the second subsidiary via its control of the first subsidiary.

f. Joint control is where no one investor can make decisions unilaterally. This occurs in a joint venture and all major decisions require the consent of all co-ventures.

g. Variable interest entities (VIEs) are separate entities created to carry out or facilitate a specific aspect of the enterprise's business; however, they are not subsidiaries.

h. A primary beneficiary is the entity that stands to gain (or lose) the most from a variable interest entity.

i. A variable interest is any participation in a VIE that stands to gain or lose through changes in the values of the VIE's assets and liabilities.

j. Non-controlling interest is a broader term than minority interest. It is the interest of shareholders who do not have a controlling interest.

k. A minority interest is those shareholders who own less than 50% of a corporation.

l. A business combination occurs when one business buys a controlling interest in another corporation, thereby obtaining control over the assets of another corporation.

m. Consolidated statements are financial statements of a parent corporation that include the assets and liabilities and the results of operations of the parent and the parent's subsidiaries, instead of reporting the subsidiaries as investments, thereby showing the parent's total economic activity.

n. The equity method of reporting intercorporate investments is a method whereby the investor corporation reports as earnings its proportionate share of the net income of the investee corporation, rather than the dividend income received from the investee. Dividends received are considered to be a distribution of the investment. Thus, any earnings of the investee that have not been remitted to the investor as dividends are added to the balance of the investment account on the balance sheet.

o. Available-for-sale securities are a type of portfolio investment. They are securities not classified as held-for-trading or held-to-maturity and do not include loans and receivables.

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p. A portfolio investment is any long-term intercorporate investment that does not result in the ability of the investor to control or significantly influence the investee corporation.
q. Unremitted earnings is the excess of the investor's share of an investee's earnings over the dividends received.
r. Other comprehensive income (OCI) is a means of reporting items that are not recognized in net income and are not capital flows (e.g., issuance of shares and dividends) between the corporation and its shareholders. OCI includes the unrealized gain/loss on available-for-sale investments for the period.

2-2: A branch is a part of a larger corporation, while a subsidiary is a legally separate corporation.

2-3: Both of these are passive investments where the investor does not have control or significant influence. The difference is that trading securities are intended to be held for the short-term, or are designated as trading securities, and available-for-sale securities are intended to be held for the long term, although not until maturity.

2-4: The three types of non-strategic investments are held-for-trading, available-for-sale, and held-to-maturity investments. Held-for-trading investments are reported at market value on the balance sheet unless there is no quoted market price, in which case cost is used. Dividends and interest received are recognized on the income statement as are any unrealized holding gains and losses. Available-for-sale investments are also reported at market value on the balance sheet, unless there is no quoted market price, in which case cost is used. Dividends and interest received, using the effective interest method, are recognized in the income statement. Unrealized holding gains and losses are recognized in other comprehensive income. When realized, the gains or losses are recognized in net income. Held-to-maturity investments are reported at cost on the balance sheet. Dividends and interest received, using the effective interest method, are recognized in net income.

2-5: Control over another corporation is usually obtained by purchasing sufficient voting shares to ensure a majority of the votes for the board of directors of the controlled corporation.

2-6: The extent of control exercised is dependent upon two primary factors: (1) whether the investor owns a majority of the voting shares; and (2) who owns the remaining shares. An ownership interest of 49% can result in no control, while an ownership interest of 51% can result in almost complete control. The investor could own convertible securities that would give it control if converted. In addition, shareholder agreements in private corporations may specify limits on control or give control to an investor that would not otherwise have control. The key factor with the definition of control is that the investor *does not need the co-operation of others*.

2-7: A corporation may control another without owning a majority of the voting shares if (1) a shareholders' agreement gives control; (2) the investor owns sufficient rights,

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warrants, and convertible securities to guarantee control if challenged; or (3) a major creditor (who also has an equity interest in the debtor) has the right to select a majority of the board of directors as a result of the debt agreement.

2-8: Yes, T is a subsidiary of P, because P's control of S gives P the ability to control S's voting of T's shares. This is called indirect control.

2-9: W Ltd. is a subsidiary of P Corporation because P can control 60% of the votes for W's board of directors through P's control of Q Corp. and R Corp. W is not a subsidiary of either Q or R, however, because neither alone can control W.

2-10: The advantage of owning 100% of a subsidiary's shares is that it gives the parent unfettered control over the subsidiary, without having to be concerned about fair treatment of any outside minority shareholders.

2-11: Less than 100% ownership enables the parent to obtain the benefits of control at less cost. It also permits the ownership participation in the subsidiary of other parties who may be beneficial to the operations of the subsidiary or to the consolidated entity as a whole.

2-12: Corporations establish subsidiaries in order to facilitate conduct of some aspect of the parent's business activities, usually for legal, regulatory, or tax reasons. Subsidiaries are usually established in each foreign country where the parent operates, and also are established to carry out separate lines of business. A multiple-subsidiary structure helps to comply with local taxation and other business requirements, and also helps to isolate the risk inherent in each line of business or geographic region of operation.

2-13: A subsidiary would be purchased in order to provide for entry into a new line of business (as a going concern), to complement the parent's existing operations, to lessen competition, to gain access to established technology, customer bases, etc., or to diversify the entity's economic sphere of operations and thereby reduce its business risk.

2-14: A purchased subsidiary will have its own management, sources of financing, legal constraints, tax environment, and so forth. Maintenance of both the existing business and the economic relationships of the new subsidiary is generally facilitated by continuing to keep the acquired company as a separate legal entity.

2-15: Two legitimate uses for a VIE are identified in the text. One use is for registered pension plans. Through the use of a pension fund VIE, the funds in the pension plan are removed from the reach of the company's management, the trustee can fulfill its obligations and the plan is administered in accordance with the pension agreement and provincial law. A second use is to securitize a company's receivables.

2-16: A VIE can escape the *CICA Handbook* definition of control if the corporation which created the VIE does not control a majority of the votes for the VIE's board of directors.

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2-17: The purpose of AcG-15 is to expand the consolidation requirements to include VIE's for which the corporation is the primary beneficiary.

2-18: A variable interest is participation in a VIE that stands to gain or lose through changes in the values of the VIE's assets or liabilities. A non-variable interest is an interest in a VIE that will not benefit from increases in the VIE's asset value. The exposure of the non-variable interest is limited.

2-19: An investee corporation would be reported on the equity basis when the investor corporation has significant influence over the investee but does not have control. Equity reporting may also be used, instead of consolidation, (at the parent's choice) when the investor corporation issues non-consolidated, special purpose financial statements, or under differential reporting.

2-20: Based on quantitative factors, the cost method would appear appropriate. (If the fair value is available, it would be reported at fair value on the balance sheet.) However, the equity method would be appropriate if ABC Corporation has significant influence over XYZ Corporation, despite the fact that the 12% ownership interest is less than the quantitative guideline of 20% for significant influence to be presumed to exist.

2-21: Some of the factors that must be considered in order to determine whether significant influence exists are the composition of the investee's board of directors, the extent and nature of intercompany transactions, and the reliance of the investee on patents, processes, managerial or technical assistance, or debt financing provided by the investor.

2-22: A joint venture is a cooperative venture between several investors, called co-venturers, who jointly control a specific business undertaking and contribute resources towards its accomplishment. Joint ventures are usually incorporated (as private corporations) but can also be unincorporated. The joint venture's strategic policies are determined jointly by the co-venturers; no one investor has control, and no investor can act unilaterally. Strategic policies require the consent of the co-venturers, as set out in the joint venture agreement (which is a type of shareholders' agreement). Therefore, there is joint control.

2-23: A joint venture exists when there is joint control. This is not to be confused with profit sharing. The distribution of profits can be unequal depending on what each venturer is contributing to the joint venture. The distribution of the profits is set out in the joint venture agreement.

2-24: Currently, in Canada, GAAP requires the use of proportionate consolidation for joint ventures. If differential reporting is adopted, owners can elect to use the cost or equity method. The equity method is used in most other countries. Therefore, it is possible, for international harmonization, that Canada will change to the equity basis.

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2-25: Two circumstances when the cost method is appropriate for strategic investments are when: the parent company is unable to exercise its control or influence; or the owners have elected to adopt the differential reporting options for investments subject to significant influence and/or investments subject to control.

2-26: Under the equity method, dividends received are credited to the investment account.

2-27: The objective of consolidated statements is to show the reader the total economic activity of the parent and its subsidiaries, as well as all of the resources that are under the control of the parent company and all of the obligations of the entire economic entity.

2-28: Other countries use the equity method to report interests in joint ventures. Canada uses the proportionate consolidation method because of the high level of joint venture activity in the resource industry. Also, proportionate consolidation provides for the public reporting of joint venture assets and liabilities.

2-29: The recording of intercorporate investments is the manner in which the investments are recorded on the books of the investor, which is usually in a way which simplifies the bookkeeping. The reporting of the investments is the manner in which the investments are accounted for on the investor's financial statements, which is in accordance with the substance of the relationship between the investor and the investee.

2-30: Both equity-basis reporting and consolidation require substantial year-end adjustments. These adjustments are made in working papers, not on the books of the investor or investee. Therefore, the investor may record its investments on its books on the cost basis, regardless of the method that is required for reporting the investments on its financial statements.

2-31: The purpose of eliminating entries is to avoid double counting, e.g., intercompany sales and offsetting intercompany receivable and payable balances.

2-32: The purpose of consolidation adjusting entries is to alter reported amounts to reflect the economic substance of transactions rather than their nominal amount.

2-33: The two different approaches for preparing consolidated financial statements are the direct approach and the worksheet approach. Both approaches provide the same result.

2-34: The sales price to the selling company is equal to the purchase price to the buying company. Therefore, the appropriate eliminating entry for intercompany sales is to reduce sales by the amount of the sale and to reduce purchases (cost of goods sold) by the amount of the purchase, both amounts being the same.

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2-35: Consolidation eliminating and adjusting entries are not entered on either company's books as they are strictly worksheet entries, prepared for reporting purposes only.

2-36: The equity method is frequently referred to as one-line consolidation because both the equity and the consolidation methods result in the same net income and shareholders' equity for the parent.

2-37: Creditors of a parent company generally do not have recourse to the assets of the subsidiaries. Therefore, creditors may want to see the unconsolidated statements of the parent in order to know exactly what the resources and obligations of the legal entity are. Shareholders (and other users) of a private company may elect to receive non-consolidated statements in order to evaluate the creditworthiness, management performance, or the dividend-paying ability of the parent entity. Finally, for tax purposes, unconsolidated legal entity statements must be provided to the Canada Revenue Agency.

2-38: When the equity method has been used to record a parent's investment in a subsidiary, it is necessary to eliminate the parent's recorded equity in the earnings of the subsidiary as well as the cost of the acquisition of, or investment in, the subsidiary.

2-39: Consolidated statements could be misleading because the combination of the parent's and subsidiaries' assets and liabilities could conceal the precarious financial position of one or more of the legal entities being consolidated, including the parent. Consolidation could make the parent look healthier than it really is as a separate legal entity.

2-40: Yes. Because the parent and the subsidiaries are separate legal entities, each can fail independently of the others.

2-41: Generally, creditors have a claim only on the assets of the corporation to which they have extended credit or granted loans. A creditor of a subsidiary can look to the parent to make good on any specific debt guarantee that the parent may have given to that creditor, but even when a guarantee exists, the creditor has no direct claim on the assets of the parent.

2-42: To qualify for differential reporting, an enterprise must not have any shares or other securities that are publicly traded, not be otherwise accountable to the public, such as a financial institution or rate-regulated enterprise, and have unanimous consent of all the owners (voting and non-voting) for the reporting options elected.

2-43: Users of private companies often prefer non-consolidated financial statements as the cost of preparing consolidated financial statements exceeds the benefits. In addition, non-consolidated financial statements permit the users to evaluate the creditworthiness, management performance and/or the dividend-paying ability of the separate entity.

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2-44: Differential reporting permits owners to elect to account for:
- investments subject to control using either the cost or equity method;
- investments subject to significant influence using the cost method;
- interests in joint ventures using the cost or the equity method; and/or
- a VIE, for which it is the primary beneficiary, using either the cost or the equity method.

CASE NOTES

CASE 2-1: MULTI-CORPORATION

Objectives of the case

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

Objectives of financial reporting

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

Accounting for the Investments

Suds Limited (SL) - MC has 100,000 out of 180,000 votes or 56%. This would indicate that MC has control and should consolidate SL. However, there are factors that indicate that MC does not have control and cannot make decisions without the cooperation of others. Control is impaired because Megan can restrict day-to-day decision making and long term plans through her ability to refuse the appointment of management and to approve significant transactions. The terms of this agreement should be reviewed including the length of time these terms are in effect. It would appear that the equity basis would be appropriate. However, if it is determined that MC does have control, consolidation would be appropriate.

Berry Corporation (BC) - MC owns 37% of the voting shares which, based on the Handbook guidelines, would indicate significant influence or the use of the equity method. However, there are factors that indicate that it has no influence and that the cost method would be most appropriate. The family has elected all members of the Board, MC has not been able to obtain a seat on the Board and all shares are closely held by family members.
[CICA adapted]

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CASE 2-2: SALIERI LTD.

Objectives of the case

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

Objectives of financial reporting

Salieri is a public company and is, therefore, constrained by GAAP, the appropriate corporations act and securities acts. In addition, the shareholders will be interested in management evaluation.

Salieri's reporting of its share investments

1. Bach Burgers, Inc.: Bach is 80%-owned by Salieri which would indicate Salieri has control. However, Bach is operated without intervention by Salieri, and Salieri apparently has only one nominee on the Bach board at present. Nevertheless, Salieri has the ability to control Bach without the cooperation of others and can easily replace the entire board of directors if it decides to. Students should understand that it is the ability to control, not the exercise of control, that determines whether a company is a subsidiary that should be consolidated. Another argument against consolidation that may come up in discussion is whether Bach should not be consolidated because it is in a totally different line of business than Salieri. Salieri is simply a diversified company that (through its subsidiaries) is operating in several lines of business. The key to consolidation is compatibility of accounting, not the compatibility of businesses.

2. Pits Mining Corporation: Salieri owns 45% of Pits. This size of ownership would normally suggest that significant influence is present since it is over the 20% guideline. In this case, however, Salieri has been blocked from exercising influence by the other shareholders. Even if Salieri is successful in gaining access to Pits's board of directors, Salieri's influence may be sharply limited by a hostile majority on the board. Cost basis reporting for the investment in Pits seems appropriate under the circumstances since Salieri has little influence over Pits.

3. Mozart Piano Corporation: Salieri has a 20% interest in Mozart, and conducts joint marketing efforts with Mozart. This interaction does not necessarily represent significant influence. The other 80% of Mozart's shares are held by the Amadeus family, which thereby has firm control. On the other hand, it could be that the Amadeus family is not actively involved with the company. In that case, Salieri could have significant influence. More information is needed as to the influence of Salieri over Mozart's business, especially as to the active or inactive nature of the Amadeus family control.

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Either equity or cost basis reporting could be appropriate, depending on the assumption made regarding significant influence.

4. Leopold Klaviers, Inc.: Leopold Klaviers is a subsidiary of Mozart, since Mozart controls 80% of the votes, and thus will be consolidated with Mozart. If Mozart is reported by Salieri on the equity basis, then Salieri’s 20% share of Mozart’s earnings will include 20% of Mozart’s 80% share of Leopold’s earnings. If Salieri reports Mozart on the cost basis, then Leopold’s earnings will have no impact on Salieri’s reporting except to the extent that Mozart’s dividends are affected.

5. Frix Flutes, Ltd.: Frix is 15% owned by Salieri. This proportion of ownership normally falls within the range that qualifies for cost basis reporting (below 20%). However, there is evidence to suggest that Salieri may have significant influence. Salieri was instrumental in helping Frix out of financial difficulties, and influence may have been acquired in the process. It is known that Salieri holds the patents that were helpful in restoring Frix’s financial health, and even if these patents pertain to only a minority of Frix’s business, they may mean the difference between a going concern and bankruptcy. Salieri also has the option of canceling the licensing agreement with short notice, thereby suggesting more influence is possible. In addition to the equity financing, Salieri may also have provided debt financing to Frix. If so, the debt may carry covenants that could be very important to Frix and that could give Salieri considerable additional influence. Obviously, additional information is needed as to the relationship between the two companies before any firm decision on equity versus cost basis reporting can be reached. Nevertheless, there are indications that equity basis reporting may be appropriate.

6. Salieri Acceptance Corporation: This is a wholly-owned subsidiary. Its function is to provide financing for Salieri’s customers. As such, the company is closely related to its parent and Salieri would be required to consolidate Salieri Acceptance Corporation.

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CASE 2-3: XYZ LTD.

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

Discussion
XYZ Ltd. (XYZ) is a corporation that must issue financial statements according to GAAP, presumably to receive an unqualified audit opinion. XYZ may or may not need to issue consolidated financial statements. We do not know if XYZ would qualify for differential reporting and need more information to determine whether this is an option. Even if it did qualify for differential reporting, the users may request consolidated financial statements. Both XYZ and Sub Limited (Sub) existed before XYZ's purchase of shares, thus the issue becomes whether XYZ Ltd. has acquired control.

XYZ has acquired all of the Class B voting shares, representing 100,000 votes. Mr. Bill, the previous owner, retained all 20,000 outstanding Class A shares, with 4 votes each, representing 80,000 votes. Presumably these are all of the voting shares outstanding. It appears that XYZ is the acquirer, since the company owns 56% (100,000/180,000) of the voting rights. This would indicate that XYZ should consolidate the operations of Sub.

However, in this case, a shareholder agreement exists which affords Mr. Bill the right to refuse the appointment of management for Sub and to approve any significant transactions of Sub. These two provisions indicate that Mr. Bill has not given up control of the "strategic operating, investing and financing policies" (paragraph 1590.03) of Sub. As a result, XYZ is in a position to significantly influence Sub, but not in a position to control it without the co-operation of Mr. Bill. Therefore, consolidation would not be an appropriate method of accounting. The equity method of reporting its investment in Sub would therefore be recommended since there is significant influence but not control.

CASE 2-4: JACKSON CAPITAL INC.

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

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Memo
To: Mr. Potter
From: CA
Re: Significant Accounting Issues, Audit Risk, and Related Audit Procedures for JCI

Accounting Issues

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

While JCI is a private company, it is unlikely that differential reporting is appropriate due to the apparent large number of shareholders. Therefore, differential reporting options will not be considered in the following analysis.

Investment in Fairex Resource Inc.

JCI hold 15% of Fairex Resource Inc., a company listed on the TSX Venture Exchange. This investment is likely a portfolio investment, since JCI holds less than 20% of the shares of Fairex and may not exercise significant influence. Since JCI management are monitoring the investee's performance for the next six months prior to making a hold/sell decision, it appears that this investment was purchased for trading and should, therefore, be classified as a trading security. However, if it can be demonstrated that management does intend to hold it for the longer term, which is evidenced by the fact that JCI is holding the investment for six months before making a decision, then it could be classified as an available-for-sale investment. Under GAAP, both types of investments are reported at fair value on the balance sheet and dividends are recognized as investment income. However, unrealized gains and losses are recognized in net income for trading securities and other comprehensive income for available-for-sale investments. We should assess JCI's intent regarding the investment in Fairex at this point in time and discuss with its management the performance of Fairex to date. This approach may help us determine the appropriate treatment for Fairex, based on the most current information possible.

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

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The basis of valuation of the investment should be disclosed. If the investment is accounted for under the equity method, we must disclose the amount of any difference between the cost and underlying net book value of Fairex's assets at the date of purchase, as well as the accounting treatment of the components of any such difference.

Investment in Hellon Ltd.

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

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

The debentures should be recorded at $1.96 million (98% of $2 million), with a discount up to the face value of the debentures. The discount should be amortized over the term of the debenture, using the effective interest method, increasing the investment income recorded on the financial statements. JCI should also accrue any interest receivable on the debentures at June 30, 2006.

The basis of valuation of the investment should be disclosed. The terms of the debentures should also be disclosed.

Loan to Ipanema Ltd.

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

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

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JCI should disclose the terms of the loan, the security, and the foreign exchange gain or loss, the currency of the loan and, if the loan is carried in excess of its fair value, disclosure of the fair value and the reason for not reducing the carrying amount.

Interest in Western Gas

JCI has a 50% interest in Western Gas, a gas exploration business in Western Canada. The 50% interest level and the fact that it is "jointly-owned" suggest that this investment is a joint venture. If joint control exits, JCI must proportionately consolidate the results in JCI's financial statements. Joint control may not exist, however, since JCI has only one member of a three-member board. Despite this fact, if board decisions require unanimous consent, JCI may still have joint control, through its effective power of veto. We should scrutinize the venture agreement to properly assess the control exercised by JCI and decide on the appropriate accounting treatment for this investment.

If we determine that JCI is participating in a joint venture in regard to Western Gas, JCI will need to disclose the total amounts and the major components of assets, liabilities, revenues, expenses and net income related to JCI's interest. JCI will also need to disclose details of the cash flows from the joint venture.

Warrants in Toronto Hydrocarbons Ltd.

The stock warrants would be considered a held-for-trading investment as it appears there is intent to generate a short term profit. These warrants would be reported at fair value and unrealized exchange gains and losses in net income.

Stock-indexed bond payable

On March 1, 2006, JCI issued long-term 5% stock-indexed bonds payable for $6 million. This bond, the principal repayment of which is indexed to the TSX Composite, bears the risk that the principal repayment will increase or decrease due to factors beyond the control of management. This factor makes valuation a key issue for this bond. There are several possible approaches to valuing the bond at the balance sheet date.

JCI could value the bond at historical cost. This valuation method would eliminate any earnings fluctuations due to revaluations caused by factors unrelated to the business. This method would not, however, reflect the amount payable at the balance sheet date.

JCI could value the bond based on the index at the balance sheet date. This method provides the best estimate of the liability at the reporting date. This method does not, however, capture the final amount that will be paid at maturity.

Revaluation of the debt raises questions regarding the treatment of the unrealized gains/losses created at each revaluation date. JCI could defer and amortize the unrealized gains or losses over the term of the debt. This approach, however, gives rise to amounts on the balance sheet that are not in accordance with the definition of an asset or a

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liability. JCI could defer and accumulate the unrealized gains or losses on the balance sheet until the maturity date of the loan, but the same problems would arise with the balances on the balance sheet. Finally, JCI could recognize the gains or losses on the income statement at each revaluation date. Immediate recognition provides better matching and reflects the risk of the instrument. It is supported by the recommendation for prospective reporting for change in estimates and by the similar treatment of foreign currency gains and losses related to bonds denominated in foreign currencies. Revaluation of the debt to fair value with recognition of the gains and losses in net income is consistent with new *CICA Handbook* Section 3855 which requires all derivative financial instruments to be measured at fair value.

JCI should disclose the interest rate, maturity date, amount outstanding, and the terms of the debt in the notes to the financial statements.

Share capital

JCI's share capital consists of 1 million 8% Class A shares redeemable at the holder's option on or after August 10, 2008. These Class A shares have some characteristics of a liability instrument (the holder has the right to require the issuer to redeem the shares), even if the legal form is equity. Since differential reporting is not an option, the redeemable shares should be presented as a liability at their redemption amount. Dividends would then be considered interest costs.

The characteristics of the Class A shares should be disclosed.

Audit Risks and Procedures

Overview

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

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

Given the high-risk nature of this engagement, we will need to perform extensive tests. We will need to focus our procedures on valuation, as it is the critical issue in this audit.

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A substantive audit approach may be the most efficient approach due to the low number of high-dollar transactions. A substantial amount of our effort should be spent on assessing and verifying the fair value of the investments.

Fairex Resource Inc.

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

Hellon Ltd.

Hellon Ltd. is a private company, and the fair value information will be more difficult to audit than in Fairex's case. We should examine the financial statements of Hellon to gain an understanding of the company and its financial situation. We should find out whether the financial statements are audited. If so, perhaps we could rely on the audited statements.

We could also perform some ratio analysis using the annual financial statements and any information gathered by the investment managers. We should compare our analysis with management's analysis and review management's assumptions for the determination of fair value (discounted cash flows, for example).

We could also have the fair value determined by appraisal and could review independent information, such as press releases.

Ipanema Ltd.

We should make sure that the loan to Ipanema is not impaired in any way. We should find out whether the Brazilian government has imposed any currency restrictions. We should also check the value of the Brazilian real at the balance sheet date and consider the foreign currency risk. The currency may suffer devaluation. We should assess the security given and determine whether the security is realistic. The Brazilian government may appropriate the power generator in the future and the generator is not movable. We should consider whether the value of the loan is affected by potentially inadequate security at this time. We should get a valuation of the underlying security.

We should review the payment history to see if there have been any late payments or if the loan is currently delinquent.

Western Gas

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Western Gas is a private corporation whose value will be difficult to determine. We should review the financial statements of Western Gas. Western Gas may also be audited. If so, we could rely on the audited statements, which may contain some fair value information. We could also have a valuation of Western Gas performed by a valuation expert. We should review the initial investment report for any pertinent information, as well as management assumptions for valuation purposes.

We may also have access to the records of Western Gas. JCI is a participant in a joint venture in this company, thereby giving us access to more detailed information on its operations.

Toronto Hydrocarbons Ltd.

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

Cash Flow Issues

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

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

[CICA, adapted]

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SOLUTIONS TO PROBLEMS

P2-1

a. If Summer's investment in Winter is a joint venture, with both Summer and other investor(s) exercising joint control over the venture, then proportionate consolidation should be used to account for the business arrangement. When there is joint control, neither Summer nor the other investor(s) can make strategic decisions unilaterally. Major decisions require the consent of all the co-venturers.

b. The equity method of accounting should be used if Summer exercises significant influence over Winter, but does not exercise control. A holding of 45% would generally be indicative of significant influence. However, if Summer is unable to obtain membership on Winter's board of directors or to participate in strategic policy making, it should treat its investment in Winter as a portfolio investment and use the cost method of accounting.

c. If Summer is able to exercise control over Winter (that is, by determining the strategic operating, investing and financing policies of Winter without the co-operation of others), it should prepare consolidated financial statements to report the investment in Winter. This would generally be evidenced by an ability to elect the majority of the board of directors of Winter. Such an ability may relate to rights, options, convertible shares, and so on, which would give it enough voting power to control the board of Summer, if exercised. Alternatively, if the other 55% of shares are widely held as portfolio investments by other investors, this may imply that Summer is able to exercise control.

(CGA, adapted)

P2-2

a. If the investment in LJ Corporation is treated as a portfolio investment, it will be reported at its market value at December 31, 2007 unless the market value is not available. If the market value is not available, it will be reported at its cost of $150,000.

b. $147,000. Being 150,000 + 20%(45,000 + 20,000) – 20%(30,000 + 50,000).

P2-3

a. Large's equity in Small's 2007 earnings is $104,000.

b. Investment account, December 31, 2007:

Original investment	$500,000
Small's earnings, 2004-2007	170,000
Less dividends received	(98,000)
Balance, December 31, 2007	$572,000

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P2-4

Max Corporation
Consolidated Balance Sheet
December 31, 2006

ASSETS		
Current assets:		
Cash	$ 120,000	
Accounts Receivable	330,000	$ 450,000
Capital assets:		
Property, plant and equipment	3,900,000	
Accumulated depreciation	(1,030,000)	2,870,000
Total assets		$3,320,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable		$ 500,000
Long-term liabilities:		
Bonds payable		1,000,000
Future income taxes		150,000
Total liabilities		1,650,000
Shareholders' equity:		
Common shares	$ 400,000	
Retained earnings	1,270,000	1,670,000
Total liabilities and shareholders' equity		

Eliminations required:
1. Intercompany receivable/payable of $ 80,000.
2. Investment account offset against Min's Common Shares, $500,000.

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

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P2-5

Chappell Inc.
Consolidated Statement of Income and Retained Earnings
Year Ended December 31, 2006

Revenues:			
Sales	$7,700,000		
Interest		180,000	$7,880,000
Expenses:			
Cost of goods sold	3,700,000		
Depreciation	760,000		
Administrative expense	1,120,000		
Income tax expense	950,000		
Other expenses	330,000	6,860,000	
Net income		1,020,000	
Retained earnings, January 1, 2006		2,440,000	
Dividends declared		(330,000)	
Retained earnings, December 31, 2006		$3,130,000	

Eliminations required:
1. $900,000 intercompany sales (Chappell's sales; Hook's cost of goods sold).
2. $80,000 accrued interest (Chappell's interest revenue; Hook's administrative expenses).
3. $100,000 intercompany dividends (Chappell's dividend revenue; Hook's dividends declared).

P2-6

Fellows Corporation
Consolidated Statement of Income and Retained Earnings
Year ended December 31, 2006

Sales (5,600 + 4,700 - 3,500)	$6,800,000
Interest, dividend and lease income (650 + 15 - 360 - 70)	235,000
Total revenue	7,035,000
Cost of goods sold (4,400 + 2,500 - 3,500)	3,400,000
Other expenses (1,300 + 1,795 - 360)	2,735,000
Total expenses	6,135,000
Net income	900,000
Retained earnings, January 1	1,430,000
Dividends declared	(700,000)
Retained earnings, December 31	$1,630,000

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

Fellows Corporation
Consolidated Balance Sheet
December 31, 2006

ASSETS	
Current assets:	
Cash	$ 205,000
Accounts receivable (700 + 135 - 200)	635,000
Temporary investments and accrued investment income (360 + 90 - 50)	400,000
Inventories	330,000
	1,570,000
Property, plant and equipment:	
Land	900,000
Buildings and equipment	1,500,000
Accumulated depreciation	(500,000)
	1,900,000
Total assets	$3,470,000
EQUITIES	
Current liabilities:	
Accounts payable (240 + 80 - 200)	$ 120,000
Dividends payable (120 + 50 - 50)	120,000
	240,000
Shareholders' equity:	
Common shares	1,600,000
Retained earnings	1,630,000
	3,230,000
Total equities	$3,470,000

Note: Thorne shows $50,000 dividends payable, which must be payable to Fellows. Since Fellows shows no dividend receivable account, the amount must be included with temporary investments.

Eliminations (not required):

Common shares	$ 500,000	
Retained earnings (ending)	250,000	
Investment in Thorne		$ 750,000

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Account	Debit	Credit
Sales	3,500,000	
Cost of goods sold		3,500,000
Interest, dividend and lease income	360,000	
Other expenses		360,000
Interest, dividend and lease income	70,000	
Interest expense		70,000
Accounts payable	200,000	
Accounts receivable		200,000
Dividends payable	50,000	
Temporary investments and accrued investment income		50,000
Long-term note payable	700,000	
Long-term note receivable		700,000

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P2-7

Empire Optical Co. Ltd.
Consolidated Income Statement
Year ended December 31, 2006

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

Empire Optical Co., Ltd.
Consolidated Balance Sheet
December 31, 2006

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

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

Eliminations (not required):

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

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

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