Chapter 14

(A) Comprehensive Revaluation of Assets and Liabilities

(B) Bankruptcy and Receivership

REVIEW QUESTIONS

1. The basic purpose behind push-down accounting is to have a subsidiary record in its records the fair value increments used by its parent company when consolidated statements are prepared, in order that the subsidiary's financial statement items reflect the cost to the parent company. This permits a more meaningful basis for evaluation and decision making.

2. If the subsidiary is 100% owned, consolidation is made simpler because when the equity method has been used the parent's investment account equals the shareholders' equity of the subsidiary, and the parent's income from subsidiary account equals the subsidiary's net income. There will be no purchase discrepancy. (Of course, if entries have been made that result in unrealized intercompany profits this statement is not true.)

If the subsidiary is less than 100% owned then consolidation is far more complex if push-down accounting has been used because the noncontrolling interest in the consolidated statements is based on asset values before push-down accounting was applied.

3. Some arguments against the use of push-down accounting are:

(a) it is a violation of the historical cost accounting model that is the foundation behind current financial accounting standards;

(b) users may be confused when trying to interpret the new amounts; and

(c) over time the lack of consistency in applying accounting principles may make the numbers less meaningful.

(d) further differences between the tax basis and the financial accounting records are created by push-down accounting.

4. The key condition that must be present is that the reorganization must result in a change in control due to the fact that a substantial realignment of nonequity and equity interests has occurred.

5. No. If the fair value established for the company as a whole is greater than the sum of the fair values of its identifiable assets less liabilities, the difference is *not* reflected as goodwill, because it is hard to justify the existence of goodwill in a company that has just experienced severe financial difficulties. Instead, the fair values of the identifiable assets and liabilities are used to value the reorganized business.

6. The two main classes of creditors are secured creditors and unsecured creditors. These can be broken down into fully secured, partially secured, unsecured with priority, and unsecured.

7. *Voluntary* bankruptcy occurs when persons make an assignment of their assets for the benefit of their creditors. In effect, the person turns over the assets to a trustee, who then distributes them in accordance with bankruptcy law. A person becomes bankrupt *involuntarily* as the result of actions initiated by that person's creditors.

8. An accounting statement of affairs is one that is prepared under a quitting concern basis and shows assets measured at fair values and classified as to their availability to satisfy the various liabilities such as fully secured, partially secured, unsecured, and unsecured with priority.

9. A *secured* creditor is one that holds a mortgage, charge, or lien against the property of a debtor for a debt due from that debtor. An *unsecured* creditor is one that holds a debt due from a debtor against which no property has been pledged.

10. A business organization can be declared bankrupt if:

(a) it makes an assignment of its assets for the benefit of its creditors;

(b) it makes a proposal to its creditors under the jurisdiction of the Bankruptcy and Insolvency Act or under the provisions of the Companies' Creditors Arrangement Act, and the proposal is rejected;

(c) a court grants a receiving order against it as a result of a petition filed by one or more of its creditors.

11. Yes, there is a difference. An *insolvent* person is one:

(a) who is *not bankrupt* but has liabilities in excess of $1,000, and

(b) is unable to discharge these liabilities, or

(c) whose assets measured at fair values are less than these liabilities.

A *bankrupt* person is one who under the provisions of the act:

(a) has made an assignment of assets for benefit of creditors, or

(b) against whom a receiving order has been made.

A bankrupt person is also usually insolvent, but an insolvent person is not necessarily bankrupt.

12. A future tax liability probably would not appear on a statement of affairs. It is the result of accounting for the difference between the carrying value and the tax basis of the company's capital assets, and represents taxes that might be payable at some future date if certain future events occur. At the time of bankruptcy, it does not represent an amount owing to the government.

13. The *Official Receiver* is a federal civil servant who oversees the administration of the Bankruptcy and Insolvency Act in a bankruptcy division.

A condition of *receivership* exists when, due to a violation of a debt covenant, a secured creditor has appointed an agent to seize the debtor's property pledged against that debt.

A *receiving order* is the order granted by a court that renders a person bankrupt and allows a trustee to seize the bankrupt's assets.

An *interim receiver* is a trustee appointed by the court to oversee a debtor's affairs during the period between the presentation of a proposal and its consideration by the creditors, or during the period between the application for and the granting of a receiving order. The trustee does not seize the debtor's assets.

The *receiver-manager* is a person (often a licensed trustee in bankruptcy) appointed by a secured creditor to seize pledged assets as a result of a loan default.

14. Deposits such as these are unsecured claims without priority. If the retailer goes bankrupt before delivering the merchandise, the customer would receive the same percentage of claims as all other unsecured creditors.

MULTIPLE CHOICE

For questions 1 to 3:

Assets

Cash	(5,000)
Current receivables (635 – 160)	475,000
Inventories (900 – 340)	560,000
Equipment (net) (670 + 200)	870,000
Total assets	1,900,000

Liabilities and shareholders' equity

Current liabilities (900 x 20%)	180,000
Note payable (900 x 50%)	450,000
Long-term liabilities	300,000
Common stock (to balance)	970,000
Retained earnings	–0–
Total liabilities and shareholders' equity	1,900,000

1. c
2. b
3. c
4. b
5. c

CASES

Case 1

To: The president of Southern Ltd.
From: Your name
Re: Asset revaluation of Northern Corp.

The pension fund managers have indicated that, because they are financing Southern's potential acquisition of the shares of Northern, Northern should reflect its assets at fair value in its balance sheet on the date of your takeover. In addition, they request that their loan also appear. Provided that you are acquiring more than 90% of Northern's shares, the fair values can be reflected as desired if Northern is required to apply push-down accounting. If the number of shares acquired is less than 90%, this would not be allowed under GAAP.

The second requirement — that the pension fund's loan be reflected — is specifically disallowed in paragraph 1625.28 of the *Handbook*. However, if it is absolutely essential that this be done, it can be achieved in the following manner:

1. Southern Ltd. will have to form a new subsidiary; let's call it "X Corp."

2. Have X Corp. borrow the money from the pension fund, with the loan guaranteed by Southern Corp. Direct X Corp. to purchase the shares of Northern Corp., paying for them with the loan proceeds and the money from Southern's investment. The assets of Northern Corp. could then be pledged as security against the pension fund loan.

3. Direct Northern Corp. to revalue its assets based on the price paid by X Corp. This concept is called push-down accounting.

4. Northern Corp. and X Corp. must now amalgamate into a single surviving company, which is a subsidiary of Southern Ltd.

I think you will agree that the balance sheet of this surviving company will contain the assets of Northern Corp. valued at market and in addition will contain the loan payable to the pension fund.

If you need further clarification, please do not hesitate to contact me.

Case 2

Date

Mr. Name
President,
Reed Corporation

Re: Accounting for your financial reorganization

I have examined the terms of the agreement between the company and its creditors, and I feel that the following accounting treatment would be appropriate.

The 10% reduction in the amount owing to trade creditors should be credited to the deficit account, thus reducing it by that amount.

The reduction of the interest rate and the extension of the maturity date on the unsecured notes will have no effect on the dollar amount of any balance sheet items, but footnote disclosure giving full details will be required.

The new share subscription by the existing shareholders will result in an increase in subscriptions receivable and an increase in the common stock account, together with associated footnote disclosure.

The exchange of debenture debt for preferred shares requires that the amount of debt that now exists be transferred to a preferred share account. Footnote disclosure of the details of this exchange and the common share conversion privilege will be required.

Any assets that have fair values that are less than carrying values should be written down to reflect their lower fair value. This write-down will increase the deficit account.

In a reorganization such as this it is considered appropriate to write off the deficit to reflect a fresh start. Such a write-off will reduce the common stock account.

Mr. President, you have expressed a desire to see assets written up to their higher fair values. Such a departure from historical costs is required under *Handbook* Section 1625 if a company has been subject to a financial reorganization, and if there has been a change of control as a result of a substantial realignment of nonequity and equity interests. Your company has had a financial reorganization but there has been no change in control. In fact the previous shareholders still own and control the company and the debenture holders now holding newly issued preferred shares can only elect two members of the board if they convert in the future. This does not constitute a change in control. As a result I must report to you that the write-up of assets would not be allowed.

Yours truly

Name

Case 3

Summerset Enterprises was declared bankrupt on March 6, 2006. On that date a receiving order was issued against it as a result of a petition to the courts by some of its unsecured creditors.

Mr. Notlih has been appointed trustee, and has seized the assets of the company. This announcement is made to notify all creditors that a meeting will be held at which time the financial situation of Summerset will be revealed by the trustee.

Unsecured creditors will advise the trustee as to the action they wish him to take. For example, they could direct him to run the business for some time and later try to sell it as a going concern. Or they may instruct him to sell the free assets piecemeal.

If your uncle is a fully secured creditor, it is possible that he will not lose any money on this, because the proceeds from the assets pledged should more than cover the amount owing.

If he is a partially secured creditor, he may suffer some loss. This is because the proceeds from the sale of the pledged assets will not be sufficient to discharge the debt to him, and therefore will leave a balance owing that is now considered an unsecured claim.

If he is an unsecured creditor the amount of his loss will depend on the size of the free asset pool (i.e., those assets that were not pledged as security for borrowings). In some cases all assets are pledged, which leaves nothing for the unsecured creditors, or the value of the free assets may be substantially less than the total claim. Your uncle should make sure he attends that first meeting of creditors.

Case 4

Because a financial reorganization has taken place resulting in the original shareholders of CREL losing control to the company's creditors, a comprehensive revaluation of assets and liabilities must take place under the requirements of Section 1625, once the court gives its approval to the plan.

The accounting implications are as follows:

- As at the date of the reorganization, all assets and liabilities will have to be revalued in accordance with the provisions of Section 1580, "Business Combinations," except that no goodwill will appear on the balance sheet. Future income tax assets or liabilities will have to be set up to account for the differences between the new fair values used and the tax bases of the individual assets and liabilities.
- Increases or decreases to equity resulting from the revaluation will not be reflected in the income statement, but probably will increase or decrease the common stock account.
- Any retained earnings (deficit) balance will be written off to the common stock account to give a "fresh start."
- New shares will be issued to fully discharge unsecured debt. The carrying value of the debt will form the basis of valuing the new shares issued.
- The deferral of payment dates on the remaining debt will have to be fully disclosed in the statement footnotes.
- The fact that the plan calls for the sale of a substantial portion of the company's assets will have to be fully disclosed.

PROBLEMS

Problem 1

Cost of investment in Sabourin			95,000
Book value of Sabourin			
Common stock		30,000	
Retained earnings		28,000	
		58,000	
		100%	58,000
Purchase discrepancy			37,000
Allocated	FV – B V		
Inventory	5,000 × 100%	5,000	
Plant	9,000 × 100%	9,000	
Trademarks	7,000 × 100%	7,000	
		21,000	
Long-term debt	– 1,000 × 100%	– 1,000	22,000
Balance – goodwill			15,000

(a) Sabourin's push-down journal entries:

Retained earnings	28,000	
Common stock		28,000
To reclassify retained earnings		
Inventory	5,000	
Plant	9,000	
Trademarks	7,000	
Goodwill	15,000	
Long-term debt	1,000	
Common stock		37,000
To revalue net assets		

(b)

Peach Corp.

Consolidated Balance Sheet

January 1, Year 2

Cash (100,000 - 95,000 + 2,000)	7,000
Accounts receivable (25,000 + 7,000)	32,000
Inventory (30,000 + 26,000)	56,000
Plant (175,000 + 60,000)	235,000
Trademarks (0 + 14,000)	14,000
Goodwill (0 + 15,000)	15,000
	359,000
Current liabilities (50,000 + 10,000)	60,000
Long-term debt (80,000 + 19,000)	99,000
Common stock	110,000
Retained earnings	90,000
	359,000

Problem 2

Cost of 100% of Stetlar (6,000 × \$4.90)			29,400
Book value of Stetlar			
Common stock		10,000	
Retained earnings		12,500	
		22,500	
		100%	22,500
Purchase discrepancy			6,900
Allocated:	FV - BV		
Inventory	– 2,800 × 100%	– 2,800	
Plant assets	5,000 × 100%	5,000	
		2,200	
Long-term debt	700 × 100%	700	1,500
Balance – goodwill			5,400

(a) Stetlar's push-down journal entries:

Retained earnings	12,500	
Common stock		12,500
Plant assets	5,000	
Goodwill	5,400	
Inventory		2,800
Long-term debt		700
Common stock		6,900

(b)

Pace Company
Consolidated Balance Sheet
as at January 1, Year 2

Cash (10 + 2)	12,000
Accounts receivable	12,000
Inventory (18 + 5.2)	23,200
Plant assets (60 + 25)	85,000
Goodwill	5,400
	$137,600
Current liabilities (20 + 5)	25,000
Long-term debt (15 + 3.2)	18,200
Common stock (30 + 29.4)	59,400
Retained earnings	35,000
	$137,600

Problem 3

Cost of investment in Scott Ltd.			261,000
Book value of Scot Ltd.			
Common stock		300,000	
Retained earnings		(40,000)	
		260,000	
Less: goodwill		30,000	
		230,000	
		100%	230,000
Purchase discrepancy			31,000
Allocated	FV – BV		
Inventory	5,000 × 100%	5,000	
Land	30,000 × 100%	30,000	
Plant and equipment	– 10,000 × 100%	–10,000	25,000
Balance – goodwill			6,000

Scott Ltd. push-down journal entries:

Common stock	40,000	
Retained earnings		40,000
To reclassify retained earnings		
Inventory	5,000	
Land	30,000	
Goodwill (6,000 - 30,000)		24,000
Plant and equipment		10,000
Common stock		1,000
To comprehensively revalue net assets		

Peko Corp.

Consolidated Balance Sheet

December 31, Year 4

Cash (10,000 + 5,000)	15,000
Accounts receivable (100,000 + 35,000)	135,000
Inventory (90,000 + 165,000)	255,000
Land (70,000 + 70,000)	140,000
Plant and equipment (360,000 + 280,000)	640,000
Goodwill (90,000 + 6,000)	96,000
	1,281,000
Current liabilities (120,000 + 80,000)	200,000
Long-term debt (320,000 + 220,000)	540,000
Common stock	400,000
Retained earnings	141,000
	1,281,000

Problem 4

Part A

Cost of 100% of Bic			97,000
Book value of Bic			
Common stock		30,000	
Retained earnings		28,000	
		58,000	
		100%	58,000
Purchase discrepancy			39,000
Allocated:	FV - BV		
Inventory	5,000 × 100%	5,000	
Plant	9,000 × 100%	9,000	
Trademarks	7,000 × 100%	7,000	
		21,000	
Long-term debt	– 1,000 × 100%	– 1,000	22,000
Balance – goodwill			17,000

Bic's push-down journal entries:

Retained earnings	28,000	
Common stock		28,000
Inventory	5,000	
Plant	9,000	
Trademarks	7,000	
Goodwill	17,000	
Long-term debt	1,000	
Common stock		39,000

Part B

Cost of 90% of Bic			63,000
Book value of Bic		58,000	
		90%	52,200
Purchase discrepancy			10,800
Allocated:	FV – BV		
Inventory	5,000 × 90%	4,500	
Plant	9,000 × 90%	8,100	
Trademarks	7,000 × 90%	6,300	
		18,900	
Long-term debt	– 1,000 × 90%	– 900	19,800
Balance – negative goodwill			– 9,000
Allocated:			
Plant	60,000/74,000 × 9,000	– 7,297	
Trademarks	14,000/74,000 × 9,000	– 1,703	– 9,000
			–0–

Bic's push-down journal entries:

Retained earnings		25,200	
Contributed surplus			25,200
90% × 28,000			
Inventory		4,500	
Plant	(8,100 - 7,297)	803	
Trademarks	(6,300 - 1,703)	4,597	
Long-term debt		900	
Contributed surplus			10,800

Problem 5

Cost of 100% of Valleys			679,800
Shareholders' equity of Valleys			
Common shares		120,000	
Retained earnings		508,800	
		628,800	
		100%	628,800
Purchase discrepancy			51,000
Allocated:	FV - BV		
Accounts receivable	24,000 × 100%	24,000 Dr	
Inventory	48,000 × 100%	48,000 Dr	
Fixed assets (net)	−90,000 × 100%	– 90,000 Cr	
		– 18,000 Cr	
Bonds payable		– 10,000 Dr	– 8,000 Cr
Balance – goodwill			59,000 Dr

Common shares on acquisition date		120,000
Adjusted for push-down accounting		
Retained earnings	508,800	
Purchase discrepancy	51,000	559,800
Common shares December 31, 2008		679,800

Goodwill July 1, 2006	59,000
Impairment loss 2007	14,750
Balance Dec. 31, 2008	44,250

Peaks Corp.

Consolidated Financial Statements

Income Statement

Year Ending December 31, 2008

Sales (1,261,000 + 1,200,000)	2,461,000
Income – other investments	25,000
	2,486,000
Cost of goods sold (840,000 + 1,020,000)	1,860,000
Depreciation (60,000 + 48,000)	108,000
Interest (37,000 + 28,900)	65,900
Other (227,000 + 97,100)	324,100
	2,358,000
Net income	128,000

Retained Earnings Statement

Year Ending December 31, 2008

Balance January 1	1,348,066
Net income	128,000
	1,476,066
Dividends	50,000
Balance December 31	1,426,066

Balance Sheet

as at December 31, 2008

Cash (120,000 + 84,000)	204,000
Accounts receivable (180,000 + 114,000)	294,000
Inventory (300,000 + 276,000)	576,000
Fixed assets (net) (720,000 + 465,000)	1,185,000
Other investments	250,666
Goodwill	44,250
	2,553,916
Current liabilities (180,200 + 115,000)	295,200
Bonds payable (315,000 + 217,050)	532,050
Common stock	300,600
Retained earnings	1,426,066
	2,553,916

Problem 6

Cost of 100% of Strand		2,500,000
Book value of Strand		
Common stock	1,600,000	
Retained earnings	400,000	
	2,000,000	
	100%	2,000,000
Purchase discrepancy		500,000
Allocated:		
Inventory (30%)	150,000	
Equipment (50%)	250,000	400,000
Balance – goodwill		100,000

The following changes to the capital stock account were made when Strand applied push-down accounting on acquisition date:

Capital stock – date of acquisition		1,600,000
Increases due to push-down accounting		
Retained earnings at acquisition	400,000	
Purchase discrepancy	500,000	900,000
Capital stock Dec. 31, Year 6		2,500,000

Pearl Company
Consolidated Income Statement
for the Year Ended December 31, Year 6

Sales (4,000 + 1,000)	5,000,000
Cost of sales (2,500 + 400)	2,900,000
Miscellaneous expense (370 + 70)	440,000
Depreciation expense (80 + 41.25)	121,250
Goodwill impairment loss	10,000
Income tax (250 + 120)	370,000
	3,841,250
Net income	1,158,750

Pearl Company
Consolidated Retained Earnings Statement
for the Year Ended December 31, Year 6

Balance, January 1	2,105,625
Net income	1,158,750
	3,264,375
Dividends	500,000
Balance, December 31	2,764,375

Pearl Company

Consolidated Balance Sheet

as at December 31, Year 6

Cash (300 + 100)	400,000
Accounts receivable (200 + 600 – 75)	725,000
Inventory (2,000 + 420)	2,420,000
Plant and equipment (3,000 + 2,340)	5,340,000
Accumulated depreciation (750 + 450.625)	(1,200,625)
Goodwill*	55,000
	7,739,375
Accounts payable (900 + 300 – 75)	1,125,000
Capital stock	3,850,000
Retained earnings	2,764,375
	7,739,375

* Goodwill at acquisition	100,000
Less impairment losses to date	(45,000)
Goodwill Dec. 31, Year 6	55,000

Problem 7

(a)

Reorganization account	412,890	
Investments		152,890
Land		120,000
Buildings		90,000
Goodwill		50,000
To revalue assets as per the reorganization agreement.		
12% first mortgage bonds	600,000	
7½% first mortgage bonds		400,000
Common stock		200,000
To exchange 12% first mortgage bonds for 7% first mortgage bonds and 25,000 common shares.		
14% debenture bonds	200,000	
5% debenture bonds		185,000
Reorganization account		15,000
To exchange 14% debentures for 5% debentures.		
Retained earnings	176,070	
Common stock		176,070
To reclassify retained earnings as at May 31.		
Common stock	397,890	
Reorganization account		397,890
To reclassify reorganization account to share capital.		

Tizoc Development Corp.

Balance Sheet

May 31 (after financial reorganization)

Cash	34,730
Investments	100,000
Land	430,000
Buildings	818,731
Accumulated depreciation	(512,481)
	870,980
Current liabilities	136,860
7½% first mortgage bonds	400,000
5% debentures	185,000
Common stock (35,000 shares)	149,120
	870,980

Problem 8

(a)

Accrued interest on notes	40,000	
Accounts payable	15,000	
Reorganization account		55,000
To revalue as per reorganization agreement		
12% bonds payable	400,000	
8% first mortgage bonds		250,000
Common stock		150,000
To exchange 12% bonds for 8% bonds and 15,000 common shares.		
Common stock	178,000	
Retained earnings		178,000
To reclassify retained earnings		
Allowance for doubtful accounts	16,000	
Patents	70,000	
Accumulated depreciation	210,000	
Reorganization account	37,000	
Accounts receivable		23,000
Inventory		20,000
Property, plant, and equipment		290,000
To revalue specific assets		
Reorganization account	18,000	
Common stock		18,000

(b)

Sussex Inc.

Balance Sheet

December 31, Year 6

(after financial reorganization)

Cash		45,000
Accounts receivable	72,000	
Less: allowance for doubtful accounts	2,000	70,000
Inventory		130,000
Property, plant, and equipment		250,000
Patents		190,000
		685,000
Accounts payable		95,000
Notes payable		150,000
8% first mortgage bonds		250,000
Common stock (24,000 shares)		190,000
		685,000

Problem 9

Pembina Manufacturing Limited.
Statement of Affairs

Book values	Assets	Estimated current values	Estimated amount available unsecured claims
	Assets pledged with fully secured creditors:		
107,000	Equipment	67,400	
	Less: mortgage note	50,400	17,000
	Assets pledged with partially secured claims:		
39,000	Inventory (deducted contra)	18,000	
	Free assets:		
4,000	Cash	4,000	
46,000	Accounts receivable	46,000	
2,000	Manufacturing supplies	1,500	51,500
			68,500
	Less: liability for funds held in trust		1,200
			67,300
	Less: unsecured claims with priority		5,800
	Net estimated amount available to unsecured creditors (75 cents on the dollar)		61,500
	Estimated deficiency to unsecured creditors		20,500
198,000			
	Total unsecured claims		82,000

Book values	Liabilities and shareholders' equity		Amount unsecured
	Fully secured creditors:		
50,000	Mortgage note payable	50,000	
400	Accrued interest	400	
	Total (deducted contra)	50,400	
	Partially secured creditors:		
21,000	Notes payable	21,000	
	Less: inventory pledged as collateral	18,000	3,000
	Liability for funds held in trust:		
1,200	Income tax and CPP withholdings (deducted contra)	1,200	
	Creditors with priority under Section 136:		
5,800	Wages (deducted contra)	5,800	
	Unsecured creditors:		
60,000	Trade accounts payable		60,000
19,000	Notes payable		19,000
	Shareholders' equity:		
100,000	Common stock		
(59,400)	Retained earnings (deficit)		
198,000			82,000

Chapter 2

Investments in Equity Securities

A brief description of the major points covered in each case and problem.

CASES

Case 2-1

A company increases its equity investment from 10% to 25%. Management wants to compare the equity method and fair value method in order to understand the affect on the accounting and wants to know which method better reflects management's performance.

Case 2-2

A company has acquired an investment in shares of another company and members of its accounting department have differing views about how to account for it.

Case 2-3

This case, adapted from a past UFE, involves a company buying back the shares from a shareholder based on the shareholder's equity adjusted for certain special provision. The student must analyze various accounting issues including the valuation of an investment of 5% in another company.

Case 2-4

This case, adapted from a past UFE, involves a parent company that is in financial difficulty. An investment in an associate has been written off and a subsidiary has been sued. The student must assess whether the company can continue to report on a going concern basis and determine what should be disclosed in the notes to the financial statements.

Case 2-5

This case, adapted from a past UFE, gives an illustration of a company that has raised money for its operations in several ways (i.e. other than raising common equity) and asks the student to analyze the accounting issues for the various types of investments.

Case 2-6

This case, adapted from a past UFE, involves a company that is considering the purchase of a 46.7% interest in another company in the scrap metal business. The student must write a memo to discuss 1) all relevant business considerations pertaining to the purchase and 2) how the purchaser should report its investment if it were to proceed with the purchase.

PROBLEMS

Problem 2-1 (20 min.)

This problem involves the calculation of the balance in the investment account for an investment carried under the equity method over a two-year period. Then, journal entries are required to reclassify and account for the investment as FVTPL for the third year.

Problem 2-2 (20 min.)

This problem involves the preparation of journal entries for a FVTPL investment for one year. In year 2, journal entries are required to reclassify and account for the investment as a held-for-significant-influence investment.

Problem 2-3 (30 min.)

This problem involves the preparation of journal entries over a two-year period for an investment under two assumptions: (a) that it is a significant influence investment and (b) that it is accounted for using the cost method.

Problem 2-4 (40 min)

This problem requires journal entries, the calculation of the balance in the investment account and the preparation of the investor's income statement under both the equity method and cost method. The investee reports a loss from discontinued operations for the year.

Problem 2-5 (40 min)

This problem compares the investment account balance, the income per year, and the cumulative income for a three-year period for a 20% investment if it was classified as FVTPL, investment in associate and FVTOCI.

Problem 2-6 (20 min)

This problem compares the investment account balance, the net income and OCI for one reporting period for an 8% investment if it was classified as FVTPL or FVTOCI. Then, the student determines which method shows the most favourable current ratio, debt-to-equity ratio and return on shareholders' equity.

Problem 2-7 (25 min)

This problem calculates the balance in the investment account and determines the total income to be reported for an investment in an associate over a four-year period. .

Problem 2-8 (30 min)

This problem requires the preparation of slides for a presentation to describe GAAP for publicly accountable enterprises for financial instruments as they relate to FVTPL, FVTOCI, held-for-significant-influence and held-for-control investments.

Problem 2-9 (30 min)

This problem requires the preparation of slides for a presentation to describe GAAP for private enterprises for financial instruments as they relate to FVTPL, FVTOCI, held-for-significant-influence and held-for-control investments.

SOLUTIONS TO REVIEW QUESTIONS

1. Over the past 12 years, there has been a move from using historical cost to using fair values for reporting investments in equity securities including investments in private companies.

2. A FVTPL investment is reported at fair value with the fair value adjustment reported in net income whereas an investment in an associate is reported using the equity method.

3. The equity method should normally be used to report an investment when the investor has significant influence over or has joint control of the investee. The ability to exercise significant influence or joint control may be indicated by, for example, representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel or provision of technical information.

4. The equity method records the investor's share of changes in the investee's equity. The investee's equity is increased by income and decreased by dividends. Therefore the investor records an increase in its equity account balance when the investee earns income, and records a decrease when the investee pays dividends.

5. The Ralston Company could determine that it was inappropriate to use the equity method to report a 35% investment in Purina in two separate types of circumstances. For example, if another shareholder group owned up to 65% of Purina's voting shares, Ralston could argue that its ownership did not provide significant influence over Purina. In this case, Ralston would likely classify the investment as a FVTPL investment and report it at fair value. Alternatively, Ralston might argue that its 35% ownership established control over Purina. This would occur if, for example, Ralston also owned convertible preferred shares that, if converted, would increase its voting share ownership to greater than 50%. In this case, Ralston would argue that it should consolidate Purina.

6. The FVTPL would have been reported at fair value. The previous investment should be adjusted to fair value on the date of the change. The cost of the new shares is added to the fair value of the previously held shares. The sum of the two values becomes the total cost of shares when calculating the acquisition differential.

7. An investor should report its share of an investee's other comprehensive income in the same manner that it would report its own other comprehensive income. Thus, the investor's percentage of the investee's OCI should be reported on a separate line below operating profit, net of tax, and full disclosure should be provided. However, the investor's measure of materiality should be used to determine whether or not the item is sufficiently material to warrant separate presentation.

8. In this case, Ashton's share of the loss of Villa ($280,000) exceeds the cost of its investment in Villa ($200,000). The extent of loss recognized by Ashton depends on whether it has legal or constructive obligations to make payments on behalf of Villa.

a) Assume that Ashton has constructive obligations on behalf of Villa because it has guaranteed the liabilities of Villa such that if not paid by Villa Ashton would have to pay on their behalf. In this case, Ashton would record 40% x $700,000 or $280,000 as a reduction of the investment account and as a recognized loss on the statement of operations. The investment account will now have an $80,000 credit balance, and should be reported as a liability.

b) However, if Ashton does not have constructive obligations with respect to the liabilities of Villa, losses would only be recognized to the extent of the investment account balance. That is, a $200,000 loss would be recognized and the investment account balance would be reduced to zero.

Ashton would resume recognizing its share of the profits of Villa only after its share of the profits equal to the share of losses not recognized ($80,000 in this case).

9. Able would reduce its investment account by the percentage that was sold, and record a gain or loss on disposition. It would then reevaluate its reporting method for the investment. If significant influence still exists, it should report using the equity method. If it no longer exists, Able should report using the fair value method and would measure any remaining interest in the investee at fair value.

10. The FVTPL reporting method would typically show the highest current ratio because a FVTPL investment is a short term trading investment, which must be shown as a current asset. For the other reporting methods, the investment could be classified as a non-current asset depending on management's intention for the investment.

11. Private enterprises may elect to account for investments in associates using either the equity method or the cost method. The method chosen must be applied consistently to all similar investments. When the shares of the associate are traded in an active market, the investor cannot use the cost method; it must use either the equity method or the fair value method.

12. IFRS 9 requires that all nonstrategic equity investments be measured at fair value including investments in private companies. However, an entity can elect on initial recognition to present the fair value changes on an equity investment that is not held for short-term trading in other comprehensive income (OCI). The gains or losses are cleared out of accumulated OCI and transferred directly to retained earnings and are never recycled through net income. Under IAS 39, investments that did not have a quoted market price in an active market and whose fair value could not be reliably measured were reported at cost. This provision no longer exists under IFRS 9.

SOLUTIONS TO CASES

Case 2-1

The investment in Ton was appropriately classified as FVTPL in Year 4 on the assumption that Hil did not have significant influence with a 10% interest.

The reporting of the investment at the end of Year 5 depends on whether Hil has significant influence. *IAS 28* states that the ability to exercise significant influence may be indicated by, for example, representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel or provision of technical information. If the investor holds less than 20 percent of the voting interest in the investee, it is presumed that the investor does not have the ability to exercise significant influence, unless such influence is clearly demonstrated. On the other hand, the holding of 20 percent or more of the voting interest in the investee does not in itself confirm the ability to exercise significant influence. A substantial or majority ownership by another investor may, but would not automatically, preclude an investor from exercising significant influence.

If Hil does have significant influence as a result of owning greater than 20% of the voting shares, it would adopt the equity method as of January 1, Year 5. The change from the fair value method to the equity method would be accounted for prospectively due to the change in circumstance. The fair value method was appropriate in Year 4 when Hil did not have significant influence. The equity method is appropriate starting at the time of the additional investment.

The additional cost of the 30,000 shares will be added to the carrying amount of the investment as at January 1, Year 5 to arrive at the total cost of the investment under the equity method.

The following summarizes the financial presentation of the investment-related information in the financial statements for Year 5. In the first scenario, the fair value method is used assuming that the investment is classified as FVTPL. In the second scenario, the equity method is used assuming that the investment is classified as significant influence (SI):

	FVTPL	**SI**
On balance sheet		
Investment in Ton	\$1,480,000[1]	\$1,416,000[2]
On comprehensive income statement		
In net income		
Dividend income	\$192,000[3]	
Equity income		\$208,000[4]
Unrealized gains	80,000[5]	______
Total	\$272,000	\$208,000

Notes:

1) 40,000 shares x 37 = 1,480,000
2) 10,000 shares x 35 + 1,050,000 + equity income for Year 5 of 208,000[4] – dividends received in Year 5 of 192,000[3] = 1,416,000
3) 40% x 480,000 = 192,000
4) 40% x 520,000 = 208,000

5) 40,000 shares x (37 – 35) = 80,000

Cost of investment (10,000 shares x 35 + 1,050,000)	$1,400,000
Hil’s share of net carrying amount of Ton’s shareholders’ equity	
(40% x [2,600,000+500,000-480,000])	1,048,000
Land	$ 352,000

No amortization of acquisition differential pertaining to land

The fair value method probably provides the best means of evaluating the return on the investment. The dividend income and the unrealized gains are reported in net income. The present bonus scheme considers net income. As such, the unrealized gains are considered when evaluating management’s performance. This is appropriate since they represent part of the return earned by Hil during the year. Under the equity method, equity income would be reported in net income and would be considered when evaluating management. The unrealized gains are not reported in net income and would obviously not be considered in evaluating management’s performance under the equity method.

Case 2-2

In this case, students are asked to, in effect, assume the role of a consultant and advise Cornwall Autobody Inc. (CAI) how it should report its investment representing 33% of the common shares of Floyd’s Specialty Foods Inc. (FSFI).

Accountant #1 suggests that the cost method is appropriate because it is really just a loan. This might have some validity because Floyd’s friend Connelly certainly seems to have come to his rescue. However, Connelly’s company did buy shares, and there is no evidence that they can or will be redeemed by FSFI at some future date. An investment in shares is not a loan, which would have to be reported as some sort of receivable. While knowledge of the business or the ability to manage it such as might be seen in the exchange of management personnel or technology, might be indicators that significant influence exists and can be asserted, the absence of knowledge of the business and ability to manage do not necessarily mean that there cannot be significant influence. They are not requirements for the use of an alternative such as the cost method.

Accountant #2 feels that the equity method is the one to use simply because the ownership percentage is over 20%. This number is a quantitative guideline only and whether an investment provides the investee with significant influence over the investee or not depends on facts other than the ownership percentage. For significant influence, the ability to influence the strategic operating and investing policies has to be present. Representation on the board of directors would be evidence of such ability. There is no evidence of board membership.

Accountant # 3 also suggests the equity method saying that 33% ownership gives them the ability to exert significant influence. Whether they exert it or not doesn't matter. This part is correct; you do not have to actually exert it. However, owning 33% does not necessarily mean that you possess this ability. Mr. Floyd was the sole shareholder of FSFI before CAI's investment, and we have no knowledge that he has relinquished some of this control to Connelly in return for his bail out.

The circumstances would seem to rule out the three possibilities presented by the accountants. The investment should be reported at fair value. The only choice (and it is a choice) is whether to report the unrealized gains in net income or other comprehensive income. More information is needed to determine whether CAI has other similar investments and what its preference is with respect to the reporting of this type of investment.

Case 2-3

Memo to: Mr. Neely
From: CPA
Re: Bruin Car Parts Inc. (BCP)

BCP's two remaining shareholders must address the fact that BCP's third shareholder is exiting the business. Having the right to demand a buyout means there is a need to perform a share valuation in accordance with the Signed Shareholders' Agreement (SSA). You have mentioned to me that our valuation must take into consideration any accounting adjustments necessary to comply with the SSA requirements, so I addressed the accounting issues I identified in the information presented and calculated a revised shareholders' equity. As well, I have computed the current taxes payable as per the terms of the buyout valuation provisions of the SSA.

First of all, you asked me to look into the accounting adjustments that may be required to BCP's draft financial statements, since the statements are used as part of the buyout of shares, pursuant to the provisions of the SSA. The SSA requires financial statements that are prepared in accordance with Canadian generally accepted accounting principles. These principles have evolved over time. Currently BCP prepares its financial statements in accordance with ASPE, and we will consider those principles in our valuation.

Accounts Receivable

We need to determine if the $500,000 account receivable, booked from a client that Jean Perron brought in, is actually collectible. From what Richard Bergeron says, the amount has been outstanding for several months. There is, therefore, uncertainty about its collection. Perron is the only one who has had contact with this client, and there are questions surrounding not just the ability to collect, but even some basic knowledge of the client itself. We should ensure that the $100,000 collected and brought in by Perron clears the bank in order to assess the amount to write down, if any, or before setting up an adequate allowance for doubtful accounts. With Perron leaving and the fact that there is no working phone number for the client, it is unlikely that the balance remaining will be collected (unless Perron is asked and able to track the company down and collect it himself on behalf of BCP).

If there is an indication that the receivable may be impaired, Section 3856 *Financial Instrument* states that the receivable should be written down to the highest of the following:

(a) the present value of the cash flows expected to be generated by holding the asset, or group of assets, discounted using a current market rate of interest appropriate to the asset, or group of assets;
(b) the amount that could be realized by selling the asset, or group of assets, at the balance sheet date; and
(c) the amount the entity expects to realize by exercising its right to any collateral held to secure repayment of the asset, or group of assets, net of all costs necessary to exercise those rights.
The carrying amount of the asset, or group of assets, shall be reduced directly or through the use of an allowance account. The amount of the reduction shall be recognized as an impairment loss in net income.

Bergeron has strong doubts that the remaining $400,000 receivable will ever be collected, which is supported by the amount of time it has been outstanding and the knowledge (or lack thereof) of the client. BCP has the option to either write off the receivable to bad debts or set up an allowance for doubtful accounts if BCP believes it might collect some of the balance. Given the facts presented, there is a strong argument that this receivable has nil realizable value and should be written down accordingly at year-end.

Inventory

<u>Obsolete Inventory</u>

It appears that there are valuation concerns regarding some inventory. There is about $200,000 of parts inventory on the books that is no longer used in the market that BCP sells to, with the possible exception of the client to whom Perron claims he can sell the inventory at cost. Given the fact that Perron is about to cut ties with BCP and is the only one who has dealt with this client, this position is doubtful. Further to this, since some of BCP's other customers have stated they believe they are no longer allowed to purchase these parts due to new legislation, there is strong evidence that the parts have no value at all.

Since these parts are now obsolete, we should group them together by nature as per Section 3031.28 and write them down to their net realizable value as per Section 3031.27. Since the value of the inventory appears to be nil the entire $200,000 should be written off. This will be included as an expense in the income statement in the period in which the write-down occurs, as per Section 3031.33, which would be in the November 30, Year 12 financial statements.

Storage Costs

The $15,000 paid for storage costs as a result of a special order should not have been capitalized to inventory and should be included in cost of goods sold. These costs were not necessary to get the inventory ready for sale.

Financial Instruments — Investment in Shares

There are doubts about the long-term prospects of the company BCP has invested in due to some litigation. BCP is considering selling its investment in the very near future. Its value has dropped by two-thirds since its acquisition. This investment is considered to be a financial asset as per Section 3856 *Financial Instruments.* When there is some indication that the value has been impaired, we must consider Section 3856.16 and .17 as referred to above.

Bergeron is fairly certain that this company will not be able to continue for long; thus, there is strong evidence of impairment. BCP has an offer of $30,000 for the investment (we aren't sure when this offer was received), and it is likely the shares will be sold next week. Therefore, under 3856.17(b), we will write the investment down to this value as at year-end and record the reduction as an impairment loss on the income statement.

Research and Development Costs

BCP has done some R&D work this year for the first time in several years. As a result, it has acquired new designs and made upgrades to its equipment. It is appropriate that these R&D costs be capitalized because BCP expects to obtain future economic benefits. Since BCP is already selling the products related to the R&D expensed, is already receiving some benefits from the R&D efforts. (

Cost of Acquiring Design and Legal Fees

Since the costs of acquiring the design and the legal fees incurred to patent the design meet the criteria for intangible assets, they should be capitalized as such. Thus, the costs to acquire the design from an engineering firm ($125,000) and the legal costs to have it patented ($10,000) should be recorded on the balance sheet as an intangible asset.

Even though the patent provides legal protection for 17 years, Bergeron has mentioned that BCP usually has to do R&D work every five years, on average, to keep up with the market before a product becomes obsolete. It would seem logical, then, that any intangible asset should be amortized over this five-year period. There may be an argument that this could be done over 17 years, but this may be optimistic given what BCP has had to do in the past. Therefore, there appears to be a reliable way to measure the expense associated with this asset, and in accordance with Section 3064.61(e), we would amortize it over a period of five years.

Costs for Modifying and Upgrading Equipment

The modifications and upgrade to the equipment were done in order to integrate the new design, which has already resulted in additional sales. BCP must decide whether the upgrade is a betterment or a maintenance expense.

Section 3061.14 provides that *"the cost incurred to enhance the service potential of an item of property, plant and equipment is a betterment,"* indicating that the service potential of a particular asset is enhanced when there is an increase in the previously assessed physical output or service capacity. The modifications to the equipment have definitely increased its service capacity, so the $40,000 costs incurred should be added to the cost of the equipment.

The asset should then be amortized in a rational and systematic manner appropriate to its nature.

Market Research Costs

Section 3064.37 indicates that *"No intangible asset arising from research (or from the research phase of an internal project) shall be recognized. Expenditure on research (or on the research phase of an internal project) shall be recognized as an expense when it is incurred."* Section 3064.39 provides examples of *"research activities"* which include *"the search for, evaluation, and final selection of applications of research findings or other knowledge."*

As such, the costs incurred to ensure that the design will be accepted by the market and generate future sales should be expensed to salaries and selling and administration costs, respectively.

Therefore, the following adjustments should be made:

R&D expenses per draft statements	$ 200,000
Less: Reclassify to property, plant and equipment	(40,000)
Reclassify to market research costs	(25,000)
Net deferred development costs (intangible asset)	$ 135,000

One year of amortization, or $27,000, should be taken on this intangible since BCP is now about one year into its five-year cycle.

Therefore, the carrying amount of the intangible asset at year-end will be $108,000.

As well, the net book value of the property, plant and equipment will be increased by a net amount of

$20,800, made up of the following:

Costs of modifications	$ 40,000
Less: Investment tax credit	(14,000)
Amortization (assumed 5 years of useful life)	(5,200)
Net adjustment to PP&E	$ 20,800

Investment Tax Credits Related to R&D

BCP expects to file a scientific research and experimental development (SR&ED) claim for its eligible R&D expenditures. We know that it expects to earn an investment tax credit (ITC) at the rate of 35% on its eligible expenditures. The costs incurred to improve the manufacturing equipment should qualify as eligible expenditures. At $40,000, this results in an ITC of $14,000.

The $14,000 ITC should be netted against the PP&E recorded on the balance sheet and accrued as an ITC receivable. There would be no impact on net income or shareholders' equity.

Restatement of Key Financial Statement Elements

After the above factors have been taken into account, net income and shareholders' equity will be adjusted as follows:

	Income before Income tax	Shareholders' Equity
Unadjusted amount per draft financial statements	$696,000	$3,330,000
Adjustments:		
1. Increase to bad debt expense	(400,000)	(400,000)
2. Inventory write-off through COGS	(215,000)	(215,000)
3. Marketing costs write-off	(25,000)	(25,000)

4. Amortization of capitalized development costs	(27,000)	(27,000)
5. Investment written down to fair value	(60,000)	(60,000)
6. Depreciation expense related to capitalized R&D equipment		
(40,000 − 14,000) / 5	(5,200)	(5,200)
Adjusted amounts	$(36,200)	$2,597,800

Taxes Payable at End of Year 12

In order to calculate income tax payable or receivable at the end of Year 12, I calculated taxable income for Year 12 as follows:

Revised income (loss) before taxes	$ (36,200)
Adjust for:	
Non-deductible penalties and interest	1,500
Depreciation expense (30,000 + 5,200)	35,200
Amortization of development costs	27,000
Impairment loss on investment	60,000
CCA	(201,268)
Taxable income (loss)	$(115,268)

Given the loss, there is no current taxes payable for Year 12. However, BCP will be able to carry forward this loss to save income tax in future years.

Determining Buyout Value

To calculate the buyout value, we must first start with the revised shareholders' equity. Then, we back out the carrying amounts of the capital assets and investment, and adjust for the fair market values of these assets. It is important to note that the financial statements have been adjusted for some of Perron's questionable sales and inventory transactions. The value of the shares is based on the adjusted financial statements, which are assumed to be a true representation of the results. However, a question arises as to whether other transactions have been manipulated by Perron to achieve the "better" results. We also wonder if some of the business expenses incurred are legitimate. This may be difficult to prove, so, for now, we have left these expenses in the business. However, should more information come to light about Perron's activities being less than legitimate, then an adjustment to the financial statements, and to the valuation, may be required. In our opinion, it would be wise to consult with legal counsel to see if an adjustment clause can be built into the buyout arrangements for any items not yet identified, that end up being uncollectible, or that affect the value assigned to the shares.

BCP will have to pay Perron about $136,000 (ignoring any taxes) per year for the next 10 years as calculated below. This will end up adding to the debt that BCP has already started to accumulate. BCP may have trouble financing this in the long term if it continues to have losses, as it has had. However, if it can collect some of its receivables and continue to generate sales and tax refunds through its R&D work, it should be able to get by. We will need to discuss the matter with Chara and Bergeron to see what options there are.

BCP

DRAFT VALUATION

As at November 30, 2012

Shareholders' equity per revised draft statements	2,597,800	
Adjust for:		
Fair value of capital assets	2,385,000	
Carrying amount of capital assets (1,150 + 40 – 14 – 5.2)	(1,200,800)	
Fair value of investment	30,000	
Carrying amount of investment (90 - 60)	(30,000)	
Tax value of losses carried forward (Note 1)	42,632	
Value of BCP common shares	3,854,632	
Perron's share (one-third)	1,284,877	
Deduct: 10% discount per clause 3 (e)	(128,488)	
Add: Shareholder loan	200,000	
Net owing to Perron	1,356,389	
Amount to pay per year (spread over 10 yrs.)		135,639

Note 1: Apply tax rate to total of losses carried forward per tax information $240,000 and current year's tax loss: ($240,000 + $115,268) × 12% = $42,632.

Other Matters

Some of Perron's actions that occurred prior to triggering the SSA buyout appear to have resulted in an inflated balance sheet, which would have increased the amount being paid out to him if not adjusted for.

According to Bergeron, only Perron had access to some clients, and there seems to be some question as to whether these clients exist. For instance, Perron made a $500,000 sale to a client this year. It is a brand new client, and $500,000 is a significant amount of sales for this company. As mentioned earlier, it is even more questionable now that Perron has suddenly come up with a $100,000 cheque from that particular client. With such a significant number, there should be some basic checks and balances to ensure others at BCP have contact with this client. Perhaps a policy should be put in place requiring that more than one shareholder meets with all major new clients, for both control purposes and business development reasons. Also, credit checks should be performed on new clients so that this kind of thing does not happen again.

Perron also seems to have been up to some other questionable activities this year. For instance, he was adamant that the $200,000 of obsolete inventory could be sold. The higher inventory balance inflates the assets on the balance sheet.

We should consider legal options. The behaviour exhibited by Perron has been at times odd, especially his defense of the new client with the warehouse address in Saskatoon. It may be possible that this client does not exist at all, and that the merchandise has been misappropriated. Legal counsel should be contacted to act further on this situation, unless Perron commits to collecting the funds in short order or making some sort of allowance in the valuation of the shares.

SSA

It sounds like the SSA was written up and then never referred to again. There appear to be some weaknesses in the current SSA. I strongly recommend that a new SSA be drawn up to avoid a forced buyout from happening again with a new partner. Even though any redemption would be subject to the relevant solvency test applicable under the *Canada Business Corporations Act*, this puts some serious cash strains on BCP. You could continue to use the same SSA with just the two remaining partners, but we do not recommended doing so. We have noted some weaknesses in the current agreement that should be rectified.

You are going to have a hard time finding the cash needed to buy out Perron. This situation could have been avoided. Any clauses allowing for one shareholder to force the company to buy them out can put the entire company at risk of failure. They should either be removed completely or modified so that the company has more control, or at least so that the time to repay can be adjusted based on the total amount of the redemption of the departing shareholder. As an example, if the amount exceeded $1 million, the shares would be redeemed over 15 to 20 years, or based on a percentage of the earnings. A potential alternative option is to keep such a clause in, but to have it subject to unanimous approval by shareholders. Another possibility is that, if a shareholder needed to get out, a discount would be applied to the overall value so that the payout would be less, allowing for more capital to be retained in the company. This would reduce the attractiveness of the clause, while at the same time allowing for a shareholder to leave if necessary.

Another option to consider is a long-term buyout, which would reduce the annual payment amount by spreading it out over more years. A new agreement could also call for more notice to be given so that appropriate steps could be taken to arrange financing and audit the statements. Having more notice would allow for more time to make a proper decision, since hasty decisions can result in errors applied or other oversights. This type of clause should be added to the SSA for the future. Once a new agreement is drafted, all shareholders should be made aware of it and told where it is located.

Because the remaining shareholders of BCP anticipate cash-flow issues as a result of the buyout, they should consider negotiating immediately with Perron to try to avoid legal disputes.

With respect to the risk that Perron has tried to influence the financial results by inflating sales and asset values, this type of situation may be avoided by requiring an audit of the financial results as part of the SSA, as well as requiring the results to be subject to an “adjustment clause” if there is evidence of manipulation.

Case 2-4

Memo to: Partner

From: CPA

Subject: Going concern status of Canadian Computer Systems Limited (CCS)

There are several factors that suggest that CCS may not be a going concern. However, many are limited to the impact of the investment in Sandra Investments Limited (SIL) on the cash flows and financial statements of CCS. Subsequent events regarding SIL suggest that CCS may be able to continue operations. Our conclusion on the going concern status of CCS will have implications with regard to disclosure and the content of our audit report.

Analysis of going concern status

General considerations

Among other things, it will be important to consider the current environmental factors when assessing the future of CCS. These include inflation projections, fluctuations in interest rates, US currency rates, economic recessions, competition in the industry, and inventory obsolescence. These factors may affect the prospects of CCS.

Impact of SIL on the financial results of CCS

The poor financial results of CCS are for the most part a direct result of its accounting treatment for its investment in SIL. SIL was de-listed by a US stock exchange, because of perceived financial difficulties. As a result of SIL's continued losses, CCS decided to write off its investment in SIL. In addition, SIL liabilities that were guaranteed by CCS were also recorded in the accounts of CCS. The write-off and assumption of SIL's liabilities adversely affected CCS's income statement, while the increase in liabilities adversely affected CCS's working capital position.

However, after CCS's year-end, SIL was able to raise US$40 million through a preferred share issue. SIL used the US$40 million to pay off the liabilities guaranteed by CCS. In addition, SIL was relisted by the stock exchange. These events do much to allay any concerns that CCS may not be a going concern.

The cash flows of CCS

Over the past two years, CCS has incurred substantial operating losses. In Year 11, losses totaled $3.58 million (Year 10 - $5.88 million). However, net income after discontinued operations was $1.94 million in Year 11 and, more importantly, net cash outflows from operations were $1.18 million. Therefore, net cash outflows from operations are substantially less than reported operating losses. Cash flows from operations are an important consideration in deciding whether CCS is a going concern.

The new equity issue being considered for the Year 12 fiscal year would help improve cash flows in the coming year, especially if any of the loans are called.

The management of CCS has partially lost control over the company's cash flows. Currently, the bank has full control over the cash flows of CCS, as it collects cash receipts and releases funds based on operating budgets. This practice is an indication that CCS is having difficulty in obtaining financing for its operations. On the other hand, interest rates charged are at 1% over prime, suggesting that the bank believes the security for the loan (accounts receivable and the floating charge debenture on all assets) is adequate. In any case, the bank's control over cash flows does ensure that adequate cash flows for operations will be maintained through these demand loans.

Assessment of the balance sheet of CCS

For the year ended September 30, Year 11, CCS has a negative shareholders' equity balance of $74.6 million (Year 10 - $76.7 million). However, this deficit was created largely by the write-off of the SIL loan guarantee of $55.42 million in Year 10. In Year 11, a further $2.83 million in interest charges was expensed. Without these expenses, shareholders' equity would have a deficit balance of only $16.35 million.

In hindsight, the write-offs were not required. The success of SIL's preferred share issue does suggest that investors have confidence in the company and, more importantly, CCS no longer has any obligation for the loan, since it has now been paid off.

IAS 36 requires that an entity shall assess at the end of each reporting period whether there is any indication that an impairment loss recognized in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset. An impairment loss recognized in prior periods for an investment in an associate shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. If this is the case, the carrying amount of the asset shall be increased to its recoverable amount. That increase is a reversal of an impairment loss.

The increased carrying amount of the investment attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset in prior years. The reversal of the impairment loss for the investment is recognized immediately in net income.

CCS's working capital deficiency of $83.71 million (Year 10 - $92.27 million) also points to a going concern problem. However, after the liabilities are reduced by the SIL loan and related interest accrued, the deficiency shrinks to $22.2 million (Year 10 - $26.37 million). A comparison of Year 10 to Year 11 results suggests that the working capital position of CCS is improving.

The mortgages payable balance of $21.6 million could also reduce the working capital deficiency. This balance had been reclassified as a current liability because of the failure of CCS to comply with debt service requirements and operating covenants. If the mortgage holder agrees to not demand payment of the mortgage and to put the mortgage loan back in good standing, then the amount should be classified as a long-term liability. The violation of the covenants could be the result of the method that was used to account for losses in SIL.

After all these deductions are made, the working capital deficiency in Year 11 would then be just $600,000 (Year 10 - $4.77 million).

The growing accounts payable of CCS ($400,000) may indicate an inability on CCS's part to pay its creditors on time. The $160,000 proceeds from the common shares issued during the year were used to satisfy liabilities owing to the company's directors and officers.

Management intends to sell property that is carried on the balance sheet at $1.85 million. The proceeds from this sale could help improve cash flows and may also indicate that management is trying to rid CCS of unprofitable and inefficient assets.

In addition, no dividends have been paid on the common shares or the preferred shares in the last two years. The non-payment of dividends is probably due to the fact that CCS is not permitted to pay dividends without the bank's approval.

Another factor that should be considered in the going concern analysis is CCS's long-term loan of $15 million, which has been in default since September 30, Year 11. This loan should be classified as a current liability unless the lender formally agrees to forgive the violation and not call the loan. In addition, any long-term debt that is payable on demand should be classified as a current liability since it can be called at any time. To avoid the classification as current liabilities, the lenders must formally agree to change the terms of the loans so that the loans are not callable on demand. The reclassification of any loans from long term to current will make the working capital situation worse and could negatively affect the CCS’s ability to continue as a going concern.

Assessment of income statement

There are signs that the company is controlling its costs. Operating expenses have decreased by 32% in Year 11 from the Year 10 amounts. In addition, it appears that CCS is discontinuing certain operations that had been contributing to its losses in prior years; these operations may also have adversely affected cash flows.

Sales fell 35% in Year 11 compared to Year 10. In addition, there is a large increase in CCS's accounts receivable balance from Year 10, which may indicate a problem with collections.

CCS has completed a new software development program that may help sales in the future. The actual impact of this new product on cash flows should be determined.

CCS may be able to borrow funds using its plant assets as collateral. These assets may have a much higher market value than those reflected on the balance sheet. There are also other bases of measurement that could be used to value the assets, such as replacement cost or fair value. These measurements provide a better reflection of the underlying value of the assets.

The pending lawsuit may result in judgments or cash awards. However, management believes that this claim is without merit, an opinion that needs to be confirmed by CCS's lawyers. Further, any amount that may be awarded pursuant to an action is recoverable under the company's insurance policies.

Other steps CCS could take

My analysis of the financial position of CCS uncovered a number of cash planning opportunities that may enable CCS to improve its profitability. Currently, CCS has a large amount of debt outstanding, with interest payable at high interest rates. Management should discuss with the bank opportunities that may be available to restructure the debt. By providing cash flow statements and budgets, management may be able to convince the bank that the risk of lending CCS funds is lower than originally perceived. Further, a greater effort could be made to sell the property held for resale. Selling SIL would also generate cash flows. In addition, CCS could increase its efforts to collect the outstanding receivables; one alternative is to sell the receivables to a credit agency.

Implications of disclosing a going concern problem in the financial statements

If it is concluded that a going concern problem exists, then we must determine the appropriate type of disclosure. The most conservative treatment that could be adopted is to use an alternative basis of measurement (e.g., liquidation value). In this case, not only will balance sheet values be changed, but the classification of assets and liabilities in the financial statements may also need to be adjusted.

We must consider whether there is adequate disclosure in the financial statements and whether disclosure explicitly draws attention to the going concern problem. In evaluating the adequacy of disclosure, we would consider the content of financial statements, including the terminology used, the amount of detail given, the location of the disclosure, and its prominence in the financial statements.

If it is decided that the going concern problem is to be disclosed in a note, and the figures used in the financial statements will not be adjusted, then certain information should be included in the note. First, the note should state that there are adverse conditions and events, which indicate that the accounting principles used, are not applicable. The note should also provide details of management's plans, if any, for dealing with the adverse conditions and events and management's evaluation of their significance for operations, as well as any mitigating factors that may be present. The possible effects on operations should be explained if the problem is not resolved. Finally, the note should state the anticipated timing of the resolution of surrounding uncertainties.

Disclosure does not have to be limited to the financial statements. Going concern problems could be communicated in media announcements or in the management discussion and analysis in the annual report, or could be included with documents filed with the provincial securities commissions.

At a minimum, going concern matters should be disclosed in notes to the financial statements. There are legal implications if a going concern problem is not disclosed properly to auditors, directors, officers, and any company administrators.

Case 2-5

Memo

To: Jules Bouchard

From: CPA

Subject: LIL’s Proposed Acquisition of MML

Attached are my comments regarding MML and its potential acquisition by LIL. Overall, I think that MML would be a risky investment for LIL, and I think that care must be exercised in undertaking it. However, given the right price and satisfactory terms, it could be worthwhile for LIL to invest.

Overview

MML is a risky investment under the proposed terms of the agreement outlined in the information I received. Under these terms, LIL would acquire 46.67% immediately and the remainder over five years. As a result, the four cousins who currently own and manage MML would be the majority owners during the first year. The cousins could use this period to make deals that serve their own interests and not the interests of MML and LIL. If MML's current management undertook such activities, LIL would be locked into a deal to purchase the shares of a company with reduced value. This situation is especially of concern because there are questions, discussed below, about the integrity of MML's management. The current owners would also be in a position to control the accounting policies used in the financial statements, which are to be used to set the selling price of the remaining shares.

LIL could take steps to mitigate these problems. The purchase agreement could be revised so that LIL gets control of MML immediately. Covenants could be written into the agreement, to restrict bonuses to the existing owners and/or to require LIL's approval for certain types of transactions.

Another problem is that MML requires an infusion of cash to pay for the needed investment in equipment, renovation of the buildings, and purchase of a competitor. MML is at the limit of its bank line of credit so the bank is not a viable source of financing. However, if LIL decides to invest in MML, MML itself will receive the proceeds of the sale of the shares; thus, the investment by LIL will meet some or all of MML's cash needs. If the investment by LIL does not meet all the needs, then additional sources of cash will have to be found.

LIL should also consider what will happen to the business when the existing owners sell all their shares. Is the business dependent on the cousins' personal contacts for success, and if so will the cousins be able to compete with MML by setting up a new scrap business? If the answer is yes, a non-compete clause should be included in the agreement of purchase and sale. Alternatively, LIL might consider hiring some or all of the existing owners to manage the business.

Finally, LIL should be made aware that historical cost financial statements are of limited use for a purchase decision. While they may provide some benchmark information, future-oriented information and fair values of assets are more relevant. Many of the problems discussed below demonstrate the limitations of the historical cost statements.

Bank loan

MML is heavily indebted. Its bank loan would typically be around $13.49 million as it tends to operate at its maximum line of credit. This amount is significant because MML's sales are about $15.675 million and MML could be in serious difficulty if the bank called the loan. The bank currently requires MML's shareholders to give personal guarantees for the loans. If LIL becomes a shareholder, the bank could request guarantees from it, which would increase its risk. MML may already be over its bank loan if, as discussed below, inventory and/or accounts receivable are overstated. In these circumstances the bank may demand the difference from MML, which would create additional pressure for MML to raise cash. If LIL invests, however, some of its cash needs may be reduced because MML would receive the proceeds from the initial purchase of shares.

Suspicious business practices

The auditors' suspicions that MML reduces the weight of scrap purchased before it calculates accounts payable suggest that MML's owners engage in unscrupulous business practices. The accounting implication of reducing the weight is to understate cost of goods sold. If MML were to pay the correct amount, the profit margin would be reduced and net income would be lower than is currently reported. In addition, MML's reputation could be damaged if such business practices came to light. If MML’s suppliers discovered these practices, they could decide to sell their scrap elsewhere, which could have a disastrous effect on the performance of MML. These suppliers are crucial to the business since they provide the inputs. On the other hand, if the number of scrap dealers in the area is limited, or the business practices apparently used by MML are widespread, then the extent of the damage resulting from suppliers discovering these practices may be limited.

Joint venture with GEL

The joint venture with GEL is 40% owned by MML and 60% owned by the spouses of the existing owners of MML. The close relationship poses some potential problems with regard to tax and financial-statement interpretation. Transactions between GEL and MML may be arranged to transfer funds to the spouses or to manipulate the financial statements of MML. If transfer pricing is not done at fair value, a tax liability may exist since the Income Tax Act requires that transactions between related parties take place at fair value. If MML pays above fair value for GEL's services, expenses for waste disposal are overstated and net income is understated. If MML pays GEL below fair value, then net income is overstated.

The existence of non-arm's length transactions makes the financial statements difficult to interpret because the economic objectives of the owners will be achieved over the two entities rather than just MML. We need to determine the basis of transactions between MML and GEL so that we can make projections about the performance of MML if LIL purchases MML. We also need to find out whether there is a long-term contract between MML and GEL regarding the pricing of transactions between them since the terms will have an effect on the future performance of MML.

Adjustments on sales invoices

Fifteen percent of MML’s sales invoices have to be adjusted. On average the adjustments are downward by 20%. The direction of the pricing errors suggests that management attempts to overstate the amount of metal that is shipped to customers rather than that the errors are random. This finding casts additional doubt on management's integrity. Because the invoices have to be adjusted, accounts receivable and sales are probably overstated. The maximum balance-sheet adjustment is $171,000 (25M + 32M) / 2) x 0.20 x 0.20 x 0.15). The overall maximum income statement effect of the reductions is $470,250 (average sales = (1.5+4 turnover) / 2) x 5.7 million of average accounts receivable = $15.675 million, so the total adjustment = $15.675 million x 0.15 x 0.2 = $470,250). Some portion of the $470,250 should be accrued at year end as sales returns and allowances because, without adjustment, accounts receivable and sales will both be overstated. This situation also raises concerns that there may be additional unrecorded adjustments to receivables that have not come to light. This amount is clearly material to LIL. If accounts receivable and sales are misstated, the purchase price for MML is affected and should be revised.

Inventory

With a value of about $19 million, inventory is the most important item on the balance sheet. Control over inventory is very weak, thus, the amount on the balance sheet cannot be relied on. Examples of the control weaknesses include perpetual records that are estimates of amounts rather than actuals, the absence of costing records for inventory pricing, lack of numerical sequence for weight tickets and the need for adjustments after inventory counts. Without reliable records, it is not possible to determine the quantity and quality of the inventory on hand and therefore the inventory's current value. The value is an important determinant of the price that LIL should pay for MML.

There are some questions about the practices of borrowing and lending inventory. Is the practice used for legitimate business purposes or to increase inventory levels at year end? Increasing year-end inventory levels would help MML keep the bank loan at a high level, which is important given its weak cash position. Also, it is unclear how the borrowed inventory is accounted for. Is it included in inventory and counted (perhaps requiring an adjustment between the records and the count)? Is it treated as a purchase and included in inventory? Given the poor record-keeping, the financial statements could be misstated as a result of these transactions.

Similarly, information is required about how MML accounts for the inventory purchased conditionally. If a significant quantity of inventory has been received on a conditional basis but not yet graded, its inclusion in inventory before it has been accepted would result in inventory being overvalued. Also, since the amount due to the vendor is not determined until the inventory is graded, year-end payables could be understated.

Overall, the information about inventory is highly suspect. Inventory represents about two-thirds of total assets. If it is materially misstated, the entire financial statements are materially misstated. If the inventory is materially misstated, the purchase price is affected because the price is based on the statements.

Other issues

The nature of the business suggests that MML may be liable for any environmental damage caused by storage of scrap and by the business activities of GEL (a waste disposal company). This possibility imposes an additional, unknown risk on LIL if it decides to buy MML.

MML's record-keeping system is weak, indicating a lack of controls. Weight tickets for sales are not numbered sequentially, so sales could be understated, in which case reported net income could be understated. If so, the understatement could lead to a tax liability for unreported income.

The terms under which MML does business with the Japanese trading company should be investigated. A substantial quantity of MML's metal purchases is made from the Japanese company, and we should confirm that the source will continue to supply MML if it is purchased by LIL. Because of the attractive terms that the Japanese company offers MML (no payments for five to six months), we should find out whether there is a special relationship (perhaps non-arm's length) between the existing owners of MML and the Japanese company.

The existence (or non-existence) of unrecorded liabilities should be investigated. For example, if MML reduces the recorded weights of scrap it has purchased or if purchase tickets are missing (because the tickets are not numbered), accounts payable may be understated.

Conclusion on purchase decision

I conclude from my analysis that, MML's financial statements are likely materially misstated because of the problems with inventory and cost of goods sold. As a result, LIL may be misled if it relies on the financial statements for its assessment of MML. The material misstatement may affect the bank's restrictive covenant and the amounts paid to the managers in bonuses, and may render the statements useless to LIL for its purchase decision.

There are a number of problems with MML that make the decision to purchase it very risky. Certainly LIL's management should have concerns about the integrity of MML’s managers as it appears that they are dishonest with their customers and suppliers. LIL might want to question whether it wants to be in business with the current owners. Many of the other problems identified earlier could be mitigated by altering the terms of the purchase and sale agreement to give control to LIL initially and/or to restrict the actions of the current owners. Given all the problems with MML, I do not think that it should be purchased by LIL. I would not dismiss completely the idea of purchasing MML, since at some price the acquisition would be attractive. However, I do advise LIL to proceed with extreme caution and to carefully consider the issues discussed in this memo.

Accounting for Investment in MML

If LIL decides to proceed with its investment in MML, then it needs to determine how to report its interest in MML. It really depends on whether it has control, significant influence or neither. This depends on the terms of the purchase and sale agreement and how closely knit are the four other shareholders. A 46.67% interest would normally imply significant influence because LIL would become the biggest individual shareholder. Although it does not have a majority interest, it only requires support from one of the other shareholders to control the majority of the votes. It likely will get some representation on the board of directors due to its large holding. It could even obtain control by insisting on control through the purchase and sale agreement. At the other extreme, it could have neither control nor significant influence if the cousins work together as a unit and do not agree to representation on the board or any loss of control through the purchase and sale agreement.

If LIL has control, it would report its interest in MML by consolidating MML in its consolidated financial statements. If it has significant influence, it would use the equity method to report its investment. If it has neither control nor significant influence, it would report its investment at fair value and choose to report the unrealized gains in net income or OCI.

SOLUTIONS TO PROBLEMS

Problem 2-1

Part A

Investment Account

January 1, Year 5		$650,000
Plus:		
Carter's Year 5 profit	$95,000	
Anderson's percentage ownership	20%	19,000
Less:		
Dividends	$60,000	
	20%	(12,000)
December 31, Year 5		657,000
Plus:		
Carter's Year 6 profit	$105,000	
Anderson's percentage ownership	20%	21,000
Less:		
Dividends	$60,000	
	20%	(12,000)
December 31, Year 6		$666,000

Part B

(a)	Investment in Carter	34,000	
	Unrealized gain on FVTPL investment		34,000
	(20,000 shares x 35 – 666,000)		
(b)	Cash (50,000 x 20%)	10,000	
	Dividend income		10,000

Record dividend revenue for Anderson's share of dividends declared and paid by Carter

	Cash (20,000 shares x 37)	740,000	

Investment in Carter		700,000
Gain on sale		40,000
Sale of investment in Carter		

Problem 2-2

Year 5

Investment in Robbin	275,000	
Cash		275,000
Cash (40,000 x 20%)	8,000	
Dividend income		8,000
Record dividend revenue declared and paid for Baskins Investment		
Investment in Robbin (20,000 shares x 16 – 275,000)	45,000	
Unrealized gain on FVTPL investment		45,000
Record the revaluation of Investment		

Year 6

Investment in Robbin (90,000 x 20%)	18,000	
Equity method income		18,000
Share of Robbin's income		
Cash (40,000 x 20%)	8,000	
Investment in Robbin		8,000
Baskin's share of dividends declared by Robbin		
Cash (20,000 x 17)	340,000	
Investment in Robbin (275,000 + 45,000 + 18,000 - 8,000)		330,000
Gain on sale		10,000
Sale of investment in Robbin		

Problem 2-3

(a)

January 1, Year 5

Investment in Stergis	1,850,000	
Cash		1, 850,000
To record purchase of 25% of Stergis.		

December 31, Year 5

Investment in Stergis	12,950	
Equity method income		12,950
To record 25% of Stergis's Year 5 net income.		
25% x $51,800 = $12,950		
Investment in Stergis	2,850	
OCI - Equity method income		2,850
To record 25% of Stergis's Year 5 OCI		
25% x $11,400 = $2,850		
Cash	18,500	
Investment in Stergis		18,500
To record 25% of Stergis's Year 5 dividends.		
25% x $74,000 = $18,500		

December 31, Year 6

Investment in Stergis	37,000	
Equity method income		37,000
To record 25% of Stergis's Year 6 net income.		
25% x $148,000 = $37,000		
Investment in Stergis	7,400	
OCI - Equity method income		7,400
To record 25% of Stergis's Year 6 OCI		
25% x $29,600 = $7,400		

Cash	18,500	
Investment in Stergis		18, 500
To record 25% of Stergis's Year 6 dividends.		
25% x $74,000 = $18,500		

Blake should disclose the following with respect to its investment in Stergis:

- The name and principal place of business of the associate
- The method used to report the investment in the associate
- Equity method income from Blake's investment in Stergis should be reported separately on the income statement and the carrying amount of this investment should be reported separately on the balance sheet
- The nature of its relationship with Stergis and its percentage ownership
- Summarized financial information for Stergis, including the aggregated amounts of assets, liabilities, revenues, and net income
- Nature and extent of any significant restrictions on the ability of Stergis to transfer funds to Blake in the form of cash dividends, or to repay loans or advances made by the entity; and
- Contingent liabilities incurred relating to its interests in associates

(b)

January 1, Year 5

Investment in Stergis	1,850,000	
Cash		1, 850,000
To record purchase of 25% of Stergis.		

December 31, Year 5

Cash	18,500*	
Dividend income**		18,500
To record 25% of Stergis's Year 5 dividends*		
*25% x $74,000 = $18,500		

December 31, Year 6

Cash	18,500	
Dividend income		18,500

To record 25% of Stergis's Year 6 dividends.

** Note that under the guidance of the Section 3051, when applying the cost method, all dividends are recorded as revenue when received or receivable regardless of whether they represent liquidating dividends.

(c)

Blake would prefer to use the equity method. Since Stergis' comprehensive income for Years 5 and 6 is greater than dividends paid for Year 5 and 6, Blake's comprehensive income would be higher under the equity method. In turn, shareholders' equity will be higher and total debt will remain the same. Therefore, the debt-to-equity ratio will be lowest under the equity method.

Problem 2-4

Part (a) Equity method

(i)	Investment in Saltspring	285,000	
	Cash		285,000
	To record 30% investment in Saltspring		
	Cash (30% x 110,000)	33,000	
	Investment in Saltspring		33,000
	Dividends received		
	Investment in Saltspring (30% x 306,000)	91,800	
	Equity method loss – discontinued operations (30% x 33,000)	9,900	
	Equity method income (30% x 339,000)		101,700
	To record 30% of Saltspring's profit and discontinued operations		

(ii)	Investment cost Jan. 1, Year 6	$285,000
	Dividends received	(33,000)
	Share of income	91,800
	Investment account Dec. 31, Year 6	$343,800

(iii)

Pender Corp

Statement of Operations

Year ended December 31, Year 6

Sales	$990,000
Equity method income	101,700
	1,091,700
Operating expenses	(110,000)
Income before income tax	981,700
Income tax expense	(352,000)
Net income before discontinued operations	629,700
Disc. Operations – Equity method loss	(9,900)
Profit	$619,800

Part (b) Cost method

(i) Investment in Saltspring	285,000	
Cash		285,000
To record 30% investment in Saltspring		
Cash	33,000	
Dividend income		33,000
Dividends received		

(ii) Investment account balance December 31, Year 6 $285,000

(iii)

Pender Corp

Statement of Operations

Year ended December 31, Year 6

Sales	$990,000
Dividend income	33,000
	1,023,000
Operating expenses	(110,000)
Income before income tax	913,000
Income tax expense	(352,000)
Profit	$561,000

Part (c)

Pender would want to use the equity method if its bias were to show the highest return on investment since the equity method takes into account the full increase in value of the investee (i.e. recognizes proportion of income earned for the year) whereas the cost method only recognizes income to the extent of dividends received.

Cost method return on investment = $33,000/ $285,000 = 11.58%
Equity method return on investment = ($101,700 - $9,900)/ $285,000 = 32.21%

Problem 2-5

(a)

(i)	22,000 shares x $20		$440,000
(ii)	Original cost	$374,000	
	Share of income (20% x (220,000 + 247,500))	93,500	
	Less: share of dividends (20% x (165,000 + 176,000))	(68,200)	
		$399,300	
(iii)	22,000 shares x $20		$440,000

(b)

(i)	**Year 4**	**Year 5**	**Year 6**	**Total**
Dividend income (1)	$33,000	$35,200	$38,500	$106,700
Unrealized gains (2)	22,000	44,000	0	66,000
Gain on sale (2)	0	0	66,000	66,000
Net income	$55,000	$79,200	$104,500	$238,700
Total OCI	0	0	0	0

(ii)	**Year 4**	**Year 5**	**Year 6**	**Total**
Equity income (3)	$44,000	$49,500	$52,800	$146,300
Gain on sale (4)	0	0	92,400	92,400
Net income	$44,000	$49,500	$145,200	$238,700
Total OCI (4)	0	0	0	0

(iii)	**Year 4**	**Year 5**	**Year 6**	**Total**

Dividend income (1)	$33,000	$35,200	$38,500	$106,700
Gain on sale	0	0	0	0
Net income	$33,000	$35,200	$38,500	$106,700
Other comprehensive income				
Unrealized gain (2)	$22,000	$44,000		$66,000
Gain on sale (5)	0	0	$66,000	66,000
Total other comprehensive income	22,000	44,000	66,000	132,000
Comprehensive income	$55,000	$79,200	$104,500	$238,700

Notes:

1. 20% x Dividends paid during year
2. 22,000 Shares x change in share price during year
3. 20% x Net income for the year
4. $506,000 – [$374,000 + ($44,000 + $49,500 + $52,800) – ($33,000 + $35,200 + $38,500)] = $92,400
5. 22,000 Shares x $23 – 22,000 shares x $20 = $66,000

(c) The total comprehensive income over the three-year period in total is the same for all three situations. However, the split between net income and OCI is not the same in total for the three situations. This is not unusual in accounting. Although the different methods report different income each year, in the long run, the total income is the same under all methods. The total income is usually equal to the difference between cash received and cash paid over the life of the investment which is $238,700 calculated as follows:

Cash received	
Proceeds from sale	$506,000
Dividends received (33,000 + 35,200 + 38,500)	106,700
Total proceeds	612,700
Cash disbursed	
Cost of investment	374,000
Change in cash	$238,700

Problem 2-6

(a)	**FVTPL**	**FVTOCI**
Investment in UP Inc. (20,000 x 11.50)	$230,000	$230,000

Net income		
Dividend income (20,000 x 0.5)	10,000	10,000
Unrealized gains (20,000 x [11.50 – 10.00])	30,000	0
Total reported in net income	40,000	10,000
Reported in OCI (20,000 x [11.50 – 10.00])		30,000

(b)

The FVTPL will report the most favourable current ratio because the investment in UP will be reported as a current asset because it is likely to be sold within a year. Under the FVTOCI, the investment in UP will likely be reported as a non-current asset. The debt-to-equity ratio will be the same under both methods because both net income and OCI end up in shareholder's equity. The FVTPL will report the most favourable return on equity because the numerator will be net income and will not include OCI. Net income is higher under FVTPL than net income under FVTOCI.

Problem 2-7

(a) (in 000s)	**Year 11**	**Year 12**	**Year 13**	**Year 14**
Investment, beginning of year	0	285	150	50
Cost	250	-	-	-
Equity method income (25%)	50	(75)	(100)	(50)[3]
Dividends received (25%)	(15)	(15)	-	-
Impairment loss	-	(45)		-
Investment, end of year	285	150[1]	50[2]	0

(b)

Equity method income (25%)	50	(75)	(100)	(50)[3]
Impairment loss	-	(45)		-
Total income	50	(120)	(100)	(50)

Notes:

1) Investment written down to recoverable amount of 25,000 x 6 = 150,000
2) Investment written down to recoverable amount of 25,000 x 2 = 50,000
3) Since Right has no legal obligation to pay any of ON's liabilities and has not committed to contribute any more funds to ON, it should not bring the balance in the investment account to less than zero.

Problem 2-8

The following slides are presented as a sample answer for this question.

Slide #1

New Carrying amounts

Type	*Measurement*	*Unrealized Gains*
FVTPL	Fair value	Net income
FVTOCI	Fair value	Other comprehensive income

- Either method can be used

Slide #2

Rationale for Fair Value

Fair value is more relevant to most users:

• Provides clearer picture of financial situation

• Improves accountability to users

• Reduces opportunities to manage earnings

Slide #3

Determining Classification of Investment

• Management chooses the classification based on:

  - whether the investment is held for short-term trading or not
  - how the manager and entity should be evaluated

Slide #4

Rationale for Reporting Unrealized Gains

• Report in net income

  - When trading in investments is part of short-term operating strategy of firm
  - Management should be evaluated on performance

• Report in other comprehensive income

  - To avoid short-term fluctuations in net income
  - Management should not be evaluated on investments, which are not actively traded

Slide #5

Other Investments	
Type	**Reporting Method**
Investment in associate	Equity method
Investment in subsidiary	Consolidation

The cost method is used for internal purposes. Investments should not be reported at cost for external reporting purposes.

Problem 2-9

The following slides are presented as a sample answer for this question.

Slide #1

Strategic Investments

Type	**Options**
Investment in subsidiary	Consolidation, cost method or equity method
Held for significant influence	Equity method or cost method

* Must use same method for all investments in the class
* When shares traded in active market
   - must report at fair value if planned to use cost method
   - unrealized gains reported in net income

Slide #2

Rationale for Flexibility

Cost – benefit considerations
• users may not require or understand the more complex reporting
• cost involved in generating the information may be excessive
• when shares are actively traded, cost of obtaining fair value information is minimal

Slide #3

Rationale for Fair Value Information

Fair value is more relevant to most users:
• Provides clearer picture of financial situation
• Improves accountability to users

• Reduces opportunities to manage earnings

Slide #4

Not-strategic Investments

• Report at cost when shares not actively traded

• Report at fair value when shares are actively traded

- unrealized gains reported in net income

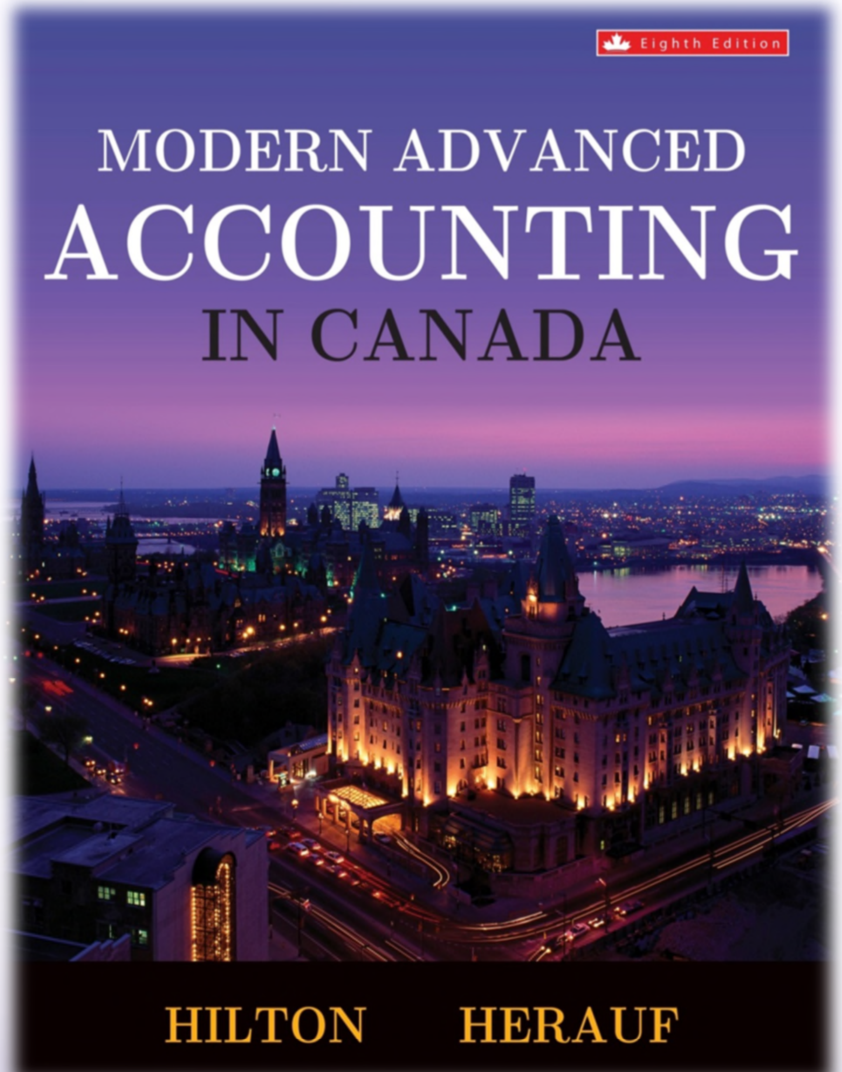
Slide #5

Rationale for Reporting Unrealized Gains

• Keep it simple

• Same as rationale above for fair value information

• OCI does not exist under ASPE



CHAPTER 2:

Investments In Equity Securities

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Learning Objectives

LO1 Describe the main changes in reporting of equity investments over the past 12 years.

LO2 Distinguish between the various types of equity investments measured at fair value.

LO3 Prepare journal entries to account for investments under the cost and equity methods.

Learning Objectives

LO4 Evaluate relevant factors to determine whether an investor has significant influence over an investee.

LO5 Analyze and interpret financial statements involving investments in equity securities.

LO6 Identify some of the differences between IFRSs and ASPE for investments in equity securities.

Equity Investments: The Big Picture

- Equity investments are investments in shares of another company.
- There are many different methods for reporting investments in equity securities.
- The methods of reporting equity investments have changed significantly over the past 12 years.

Equity Investments: The Big Picture

- There is now a trend to measure more assets at fair value on an annual basis.
- Prior to 2005, these investments were typically reported at some cost-based amount.
- IAS 39 was introduced in 2005 where for the first time it was possible to report certain investments at fair value.

LO1

Equity Investments: The Big Picture

- In 2009, IASB introduced a new accounting standard for nonstrategic investments, IFRS 9

- IFRS 9 will be mandatorily effective for fiscal periods beginning on or after January 1, 2018, early adoption is permitted.

- IFRS 9 requires that all nonstrategic investments be reported at fair value, including investments in private companies.

Equity Investments: The Big Picture

- In IFRS 9, Available-for-sale investments have been eliminated as a separate category of investments.

- In 2011, IASB introduced a new accounting standard, IFRS 13 which replaced the fair value measurement guidance previously contained in individual IFRSs.

Equity Investments: The Big Picture

- Strategic investments are reported at values other than fair value.
- Non-strategic investments are reported at fair value.

Equity Investments: The Big Picture

Reporting methods for investments in equity securities

Type of Investment	Reporting method	Reporting Unrealized gains/losses
Significant influences	Equity method	Not applicable
Control	Consolidation	Not applicable
Joint control	Equity method	Not applicable
FVTPL	Fair value method	In net income
Other – elect FVTOCI	Fair value method	In OCI

Investments Measured at Fair Value

- IFRS 9 deals with two types of equity investments:
  - FVTPL: fair value through profit or loss
  - FVTOCI: fair value through OCI

Investments Measured at Fair Value

Fair Value Through Profit and Loss (FVTPL) Investments

- Include investment held for short-term trading and any other investments reporting entity wishes to designate as FVTPL.
- Classified as current assets since they actively trade and are intended to be sold within one year.
- Recorded at fair value. Unrealized gains and losses as well as dividends received or receivable are reported in income.

Investments Measured at Fair Value

Fair Value Through OCI (FVTOCI) Investments

- Classified as current or noncurrent assets depending on how long management intends to hold to these shares.
- Unrealized gains/losses are recorded in other comprehensive income (OCI). Dividends are recorded in income.
- The cumulative gains or losses are cleared out of accumulated OCI and transferred directly to retained earnings. This usually occurs when the investment is sold or derecognized but could be transferred at any time.

Cost Method of Reporting an Equity Investment

- Cost method is used under IFRS in the following situations:
  - For investments in controlled entities (Chapter 3)
  - For available-for-sale investments when market value is not reliably measurable until 2018 (IAS 39)
  - For a parent company's internal accounting records prior to preparing consolidated financial statements (Chapter 5)
- Cost method is allowed under ASPE for equity investments that are not quoted in an active market.

Cost Method of Reporting an Equity Investment

- Under the cost method:
  - Investment is initially recorded at cost.
  - Impairment losses are reported in net income.
  - Investor's share of dividends are reported in income.
  - When investment is sold, the realized gains or losses are reported in net income.

Equity Method of Reporting an Investment in Associate

- Equity method applies to investments in associates, where the investee has the ability to exercise significant influence. Indications of significant influence include:
  - Representation on board of directors.
  - Participation in policy-making processes or decisions about dividends and distributions.
  - Material transactions between investor and investee.
  - Interchange of management personnel.
  - Provision of essential technical information.

Equity Method of Reporting an Investment in Associate

- Generally holding between 20% and 50% of voting shares indicates the presence of significant influence, however a holding of this size does not necessarily mean that such influence exists.

- Determination of significant influence requires the application of judgment.

- When one investor has control, other investors usually do not have significant influence.

Equity Method Basics

- The equity method records the investor’s share of the changes in the associate’s shareholders’ equity.
- Adjustments are made for acquisition costs greater than book value, unrealized intercompany profits, impairment losses, and other factors.
- The equity method provides information on the potential for future cash flows.

Equity Method Basics

- Using the equity method, the investor:
  - Records its proportionate share of the investee's operating income as its own operating income
  - Reduces the investment account by its share of investee dividends received
  - Records its proportionate share of the investee's non-operating income (e.g. discontinued operations, comprehensive income) separately
  - Amortizes acquisition costs greater than book value of investee ("acquisition differential") – discussed in later chapters
  - Eliminates after-tax unrealized intercompany profits (Chapters 6 and 7)

Equity Method Accounting

- Initial investment is recorded at cost

<u>EXAMPLE</u>

On January 1, 2015, New Inc. buys 30% of Newer Co for $1,500,000 cash.

Prepare the journal entry to record the acquisition on New's books

Date	Description	Debit	Credit
1- Jan	Investment in Newer Co.	$1,500,000	
	Cash		$1,500,000
	To record investment in Newer		

Equity Method Accounting

- Investor recognizes its share of investee's net operating income (loss) on the income statement
  - Based on percentage ownership

EXAMPLE

For all of 2015, Newer's net operating income was $400,000.

Prepare the journal entry for New.

Equity Method Accounting

New's ownership percentage x Newer's net Income = 30% x $400,000 = $120,000

Date	Description	Debit	Credit
31-Dec	Investment in Newer Co.	$120,000	
	Equity method income		$120,000
	to record equity in Newer net operating income		

Equity Method Accounting

- Dividends paid by the investee are treated as a reduction of the investor's investment account

<u>EXAMPLE</u>

Also in 2015, Newer paid $70,000 of dividends to Its shareholders

Prepare the journal entry to record New's receipt of its portion of the dividends from Newer.

Equity Method Accounting

- **New's ownership percentage x Newer's dividend = 30% x $70,000 = $21,000**

Date	Description	Debit	Credit
31-Dec	Cash	$21,000	
	Investment in Newer Co		$21,000
	to record receipt of dividend from Newer Co.		

Note: If Dividends are declared debit Dividends Receivable

Equity Method Accounting

- Investee records its share of investee's non-operating income/loss

EXAMPLE

Also in 2015, Newer recorded a discounted operations loss of $100,000 (net of tax) and $10,000 other comprehensive income (net of tax)

Prepare the journal entry to record New's portion of this loss from discontinued operations and other comprehensive income.

Equity Method Accounting

- **New's ownership percentage x Newer's discontinued operations loss = 30% x $100,000 = $30,000**
- **New's share of other comprehensive income = 30% x $10,000 = $3,000**

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Date	Description	Debit	Credit
31-Dec	Investment in Newer Co		$ 27,000
	Discontinued operations -investment loss	$30,000	
	Other comprehensive income		$ 3,000
	to record discontinued loss and other comprehensive income from Newer		

Equity Method Accounting

- Investor amortizes acquisition costs paid in excess of book value ("acquisition differential")

EXAMPLE

When New paid $1,500,000 for Newer on January 1, 2015 Newer's net book value was $5,000,000 (New's 30%) share = $1,200,000. New's $300,000 acquisition differential was attributable entirely to a building owned by Newer, with a 20–year remaining life, the fair value of which was $1,000,000 greater than its book value.

Prepare the journal entry to amortize the acquisition differential on New's books for 2013

Equity Method Accounting

- New's ownership percentage x acquisition differential allocated to building / remaining life
  = 30% x $1,000,000 / 20 years = $15,000
  ($300,000 / 20 years)

	Description	Debit	Credit
31-Dec	Equity method Income	$15,000	
	Investment in Newer Co.		$15,000
	To amortize acquisition differential re Newer Co.		

- this is further discussed in Chapter 5

Equity Method Accounting

- Investor eliminates unrealized profits on intercompany transactions until the assets are sold to outsiders or consumed by the purchaser.

EXAMPLE

In 2015 New sold inventory for $100,000 to Newer and recorded a 40% gross profit on the transaction. Newer's inventory still contains all of these items on December 31, 2015. New pays income tax at a rate of 30%

Prepare the journal entry to eliminate the unrealized Intercompany profit on New's books for 2015.

Equity Method Accounting

- Downstream sale (investor selling to investee, investor's books reflect profit)
  - eliminate 30% x $100,000 x 40% gross profit x (1-30% tax rate) =

  $30,000 x 40% gross profit x 70% = $8,400

Date	Description	Debit	Credit
31-Dec	Equity method income	$ 8,400	
	Investment in Newer Co.		$ 8,400
	to eliminate unrealized downstream profit on sale to Newer Co.		

- this is further discussed in Chapters 6 and 7

Other Equity Accounting Considerations

- Other changes in associate's equity:
  - The investor's statement of comprehensive income should reflect its share of the investee's income according to its nature and the different statement classifications.
  - The investor's shares of income from continuing operations, discontinued operations, and other comprehensive income are reported separately.
  - Many accounting procedures required for consolidated purposes are also required under the equity method.

Other Equity Accounting Considerations

- Acquisition costs greater than carrying amounts:
  - The investor's cost is usually greater than its share of the carrying amount of the associate's net assets.
- Unrealized profits:
  - Consolidated statements should reflect only the results of transactions with outsiders.
  - Profits from intercompany transactions must be eliminated until the assets are sold to outsiders or used in producing goods or providing services to outsiders.

Other Equity Accounting Considerations

- Changes to and from the equity method:
  - Changes in reporting methods are accounted for prospectively if they are changed because of a change in circumstance.

- Losses exceeding the balance in the investment account:
  - If an investor guaranteed an investee's obligations, the investor could end up reporting its investment as a liability rather than an asset.
  - Other long-term interests in the associate may have to be written down when the associate is reporting losses.

- Impairment Losses:
  - If there is an indication that the investment may be impaired, the investment is tested for impairment.

Other Equity Accounting Considerations

- Gains and losses on sale of investments:
  - Average cost should be used in determining any gain or loss when an investor sells part of its investment.
- Held for sale:
  - Investments in associates that meet the criteria to be classified as held for sale should be measured at the lower of carrying amount and fair value less costs of disposal, and should be reported as current assets.
- Presentation and disclosure requirements:
  - The fair value of an investment in associate should be disclosed when it is readily available.

Analysis and Interpretation of Financial Statements

- See Exhibit 2.3 -- Impact of Reporting Methods on Key Financial Ratios
- The FVTPL investment must be shown as a current asset, whereas the other investments could be current or noncurrent depending on management's intentions.
- The FVTPL investment shows the best liquidity and profitability.

LO6

IFRS versus ASPE

- CPA Canada Handbook Part II Sections 3051 and 3856:
  - Permits use of either equity or cost method to account for all significant influence investments that are not publicly traded on the same basis.
  - Investments in and income from cost-accounted investments should be reported separately, net of any impairment losses which are reported in net income.
  - Allows investors to elect to report any equity investment at fair value -- report in net income.
  - Prohibits use of the cost method to account for publicly traded investments, which must be reported at fair value with changes reflected in net income.
  - Does not require amortization of the acquisition differential
  - Other comprehensive income does not exist under ASPE.