**CHAPTER 1**

**Accounting for Investments**

BRIEF EXERCISES

BRIEF EXERCISE 1-1

What is a financial asset?

According to *IAS 32.11*, a financial asset is defined as any of the following:

* Cash
* An equity instrument of another company
* A contractual right to receive cash or another financial asset from another company
* A contractual right to exchange financial instruments with another company under conditions that are potentially favourable.

BRIEF EXERCISE 1-2

What are the three main criteria to determine control?

According to *IFRS 10.6*, the three main criteria that must be present in order for there to be control are that the parent company must have:

* The ability to direct the financial and operating policies of another company (the power criterion),
* The ability to obtain returns from the other company (the returns criterion), and
* The ability to use its power to affect those returns (the link criterion).

BRIEF EXERCISE 1-3

What is an associate company?

Paragraph 2 of *IAS 28* defines an associate as:

*An entity, including an unincorporated entity such as a partnership, over which the investor has significant influence, and that is neither a subsidiary nor an interest in a joint venture.*

The key characteristic in determining whether an investment is an associate is significant influence.

BRIEF EXERCISE 1-4

Why are associates distinguished from other investments held by the investor?

The suite of accounting standards provides different levels of disclosure dependent on the relationship between the investor and the investee.

Subsidiaries: a control relationship

Joint arrangements: a joint control relationship

Associates: a significant influence relationship

Other investments: no relationship

When there is a relationship, it relates to the ability of the investor to influence the direction of the investee, in comparison to a simple holding of shares as an investment. Where such a relationship exists, it is argued that the investor is affected, from an accountability perspective as well as a potential receipt of benefits perspective [why get involved if there are no benefits to doing so?]. These effects result in the need for additional disclosure about the relationship.

BRIEF EXERCISE 1-5

Discuss the similarities and differences between the criteria used to identify subsidiaries and those used to identify associates.

A subsidiary is identified where another entity controls that entity. Control is defined in *IFRS 10.6*.

Control: Note that three criteria must be present in order for there to be control. The parent must have:

* The ability to direct the financial and operating policies of another entity (the power criterion),
* The ability to obtain returns from the other company (the returns criterion), and
* The ability to use its power to affect those returns (the link criterion).

An associate is identified where another entity has significant influence over that entity. Significant influence is defined in *IAS 28.2*.

Significant Influence has the following features in its definition:

* The power to, or capacity, to affect the investee
* To participate in the financial and operating policy decisions of the investee
* There is no requirement for the investor to hold and ownership interest in the investee

BRIEF EXERCISE 1-6

What is meant by “significant influence”?

Paragraph 2 of *IAS 28* defines significant influence as:

*The power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.*

BRIEF EXERCISE 1-7

What factors could be used to indicate the existence of significant influence?

*IAS 28* presents several factors which could be used to indicate the existence of significant influence:

* Where an investor holds, directly or indirectly, 20% or more of the voting power of the investee, it is presumed that the investor has significant influence over the investee.
* If the investor can demonstrate that such influence does not exist, the investee is not classified as an associate.
* Where the investor owns less than 20% of another company, there is a presumption that the investee is not an associate.
* A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

Some additional factors that can provide evidence of the existence of significant influence are:

* Representation on the board of directors or the equivalent governing body of the investee.
* Participation in the policy-making processes of the investee, including participation in decisions about dividends or other distributions.
* Material transactions between the investor and the investee.
* Interchange of managerial personnel.
* Provision of essential technical information .

BRIEF EXERCISE 1-8

Discuss the relative merits of accounting for investments at cost, at fair value, and using the equity method.

**Cost Method:**

|  |  |
| --- | --- |
| *Advantages*: | – Simplicity– Reliable measure |
| *Disadvantages*: | – No indication of changes in value since acquisition– Revenue recognized only on dividend receipt |

**Fair Value Method**:

|  |  |
| --- | --- |
| *Advantages*: | – Up-to-date value, present information compared with past information– Revenue recognized as value changes, rather  than waiting for dividends |
| *Disadvantages*: | – Reliability a function of how active the market is– Costs associated with regular updating, extra costs for audit and valuation fees |

**Equity Method**:

|  |  |
| --- | --- |
| *Advantages*: | – Carrying amount related to change in wealth of  the investee– Revenue recognized prior to dividend receipt |
| *Disadvantages*: | – Carrying amount reliant on validity of investee  information– Carrying amount not based on market value– Recognition of revenue prior to associate declaring dividend; no transaction has yet  occurred |

BRIEF EXERCISE 1-9

What is a parent-subsidiary relationship?

According to *IFRS 10*, a parent-subsidiary relationship exists when a company has control over another company.

BRIEF EXERCISE 1-10

What is the key difference between a joint operation and a joint venture?

According to *IFRS 11*:

**Joint Operation**

* The parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

**Joint Venture**

* A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

EXERCISES

EXERCISE 1-1

|  |  |  |  |
| --- | --- | --- | --- |
| March 1, 2013 | FVTPL—Investment | 840 |  |
|  |  Cash |  | 840 |
|  | (To record the acquisition at fair value = $4.20 × 200 shares) |  |  |
|  |  |  |  |
| March 1, 2013 | Transaction expenses | 120 |  |
|  |  Cash |  | 120 |
|  | (To record the transaction costs) |  |  |
|  |  |  |  |
| December 31, 2013 | FVTPL—Investment | 180 |  |
|  |  Gain on Change in fair valueof FVTPL Investment |  | 180 |
|  | (To record the change in fair value at year-end)[(200 × $5.10) – $840 = $180] |  |  |
|  |  |  |  |
| February 1, 2014 | Cash | 1,020 |  |
|  |  FVTPL—Investment |  | 1,020 |
|  | (To record the sale of the investment) |  |  |
|  |  |  |  |
| February 1, 2014 | Transaction expenses | 50 |  |
|  | Cash |  | 50 |
|  | (To record the transaction costs) |  |  |

EXERCISE 1-2

|  |  |  |  |
| --- | --- | --- | --- |
| (a) January 1, 2013 | Investment in Associate | 80,000 |  |
|  | Cash |  | 80,000 |
|  | (To record the investment in Guarasci) |  |  |
|  |  |  |  |
| December 31, 2013 | Investment in Associate | 20,000 |  |
|  |  Share of Profit of Associate |  | 20,000 |
|  | (To record the share of the associate’s profit = $50,000 × 40% = $20,000) |  |  |
|  |  |  |  |
| December 31, 2013 | Cash | 4,000 |  |
|  |  Investment in Associate |  | 4,000 |
|  | (To record the adjustment for dividend paid by associate = 40% × $10,000 = $4,000) |  |  |
|  |  |  |  |
| December 31, 2014 | Share of Loss of Associate | 2,000 |  |
|  |  Investment in Associate |  | 2,000 |
|  | (To record the share of the associate’s loss = $5,000 × 40% = $2,000) |  |  |
|  |  |  |  |
| December 31, 2014 | Cash | 4,000 |  |
|  |  Investment in Associate |  | 4,000 |
|  | (To record the adjustment for dividend paid by associate = 40% × $10,000 = $4,000) |  |  |
|  |  |  |  |

|  |  |  |
| --- | --- | --- |
| (b) | Beginning balance of Invesment in Associate—Guarasci | $ 80,000 |
|  | Share of 2013 associate’s profit | 20,000 |
|  | 2013 Dividend adjustment  | (4,000) |
|  | Share of 2014 associate’s loss | (2,000) |
|  | 2014 Dividend adjustment |  (4,000) |
|  | 2014 ending balance of Investment in Associate—Guarasci | $ 90,000 |

EXERCISE 1-3

|  |  |  |  |
| --- | --- | --- | --- |
| (a) | Investment in Joint Venture | 160,000 |  |
|  |  Cash |  | 160,000 |
|  | (To record the investment in the joint venture) |  |  |
|  |  |  |  |
|  | Investment in Joint Venture | 3,850 |  |
|  |  Share of profit of joint venture |  | 3,850 |
|  | (To record Campbell Ltd. share of the profit of the joint venture = $17,500 × 22% = $3,850) |  |  |

(b) If this was a joint operation, they would report its proportionate share of each asset and liability, revenue, or expense that it owns. As they obtained a 22% interest, they would record the same 22% share of the investment income as above. Any asset or liability that it owns would be recorded.

PROBLEMS

PROBLEM 1-1



PROBLEM 1-2

1. Calculate the balances to be reflected on the Acme December 31, 2013 statement of financial position in accordance with ASPE.
* #1 — 10% interest in Plato purchased on January 1, 2013. As at December 31, 2013 they should measure the equity instrument at the fair value ($16,000), as this would be considered to be a non-strategic investment (financial asset) and any gain or loss would be flowed directly through net income. This investment in Plato would not be reported at the cost of $17,000 because the $16,000 fair value seems to be impaired when compared to the cost, and as such it should be recorded at the impaired value.
* #2 — 40% interest in Bloor purchased 5 years ago. This investment would be considered to be an associate as they are presumed not to have control. Under ASPE, they have the choice of using the equity method or the cost method.

If using the equity method, the carrying balance of the investment would be:

Beginning investment balance: $250,000

Retained earnings increase: $28,000 (40% × $70,000)

Ending investment balance: $278,000

The fair value of the investment is $280,000. As the investment is not impaired, it will be recorded at its carrying value of $278,000.

If using the cost method, it would be recorded at $250,000.

* #3 — 50% interest in a joint venture, Rand. Under ASPE, they would have the choice of using proportionate consolidation, the equity method, or the cost method to account for their interest in Rand. If using the equity method, the carrying balance of the investment would be as follows:

Beginning balance: $120,000

Net income share: $20,000 (50% × $40,000)

Dividend share: ($5,000) (50% × $10,000)

Ending balance: $135,000

If using the cost method, the investment carrying value would be $120,000.

If using proportionate consolidation, there would be no investment on the statement of financial position and it would be replaced with their proportionate share of the assets and liabilities of Rand.

PROBLEM 1-2 (Continued)

1. What will be different in the reporting of these investments for Acme if it were to become a public company?
* #1 — 10% interest in Plato purchased on January 1, 2013. As at December 31, 2013 they should measure the equity instrument at the fair value ($16,000), as this would be considered to be a non-strategic investment (financial asset) and any gain or loss would be flowed directly through net income.
* #2 — 40% interest in Bloor purchased 5 years ago. This investment would be considered to be an associate as they are presumed not to have control. Under IFRS, they would have to use the equity method.

If using the equity method, the carrying balance of the investment would be:

Beginning investment balance: $250,000

Retained earnings increase: $28,000 (40% × $70,000)

Ending investment balance: $278,000

The fair value of the investment is $280,000. As the investment is not impaired, it will be recorded at its carrying value of $278,000.

* #3 — 50% interest in a joint venture, Rand. Under IFRS, they would have to use the equity method to account for their investment in Rand. If using the equity method, the carrying balance of the investment would be as follows:

Beginning balance: $120,000

Net income share: $20,000 (50% × $40,000)

Dividend share: ($5,000) (50% × $10,000)

Ending balance: $135,000

WRITING ASSIGNMENTS

WRITING ASSIGNMENT 1-1

According to IAS 28, significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

If an investor holds, directly or indirectly (i.e., through subsidiaries), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (i.e., through subsidiaries), less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

* Representation on the board of directors or equivalent governing body of the investee;
* Participation in policy-making processes, including participation in decisions about dividends or other distributions;
* Material transactions between the investor and the investee;
* Interchange of managerial personnel; or
* Provision of essential technical information.

Points of discussion:

Why the investment was undertaken by Cornett Chocolates Ltd. is irrelevant. The definition of significant influence is based on the capacity to participate, not the actual participation or intention to participate. Therefore, their intention to only invest for cash flow reasons is not relevant in determining if Cornett Chocolates Inc. has significant influence over Concertina’s Milk Ltd.

Whether Cornett Chocolates Ltd. Actually exerts influence is irrelevant, but rather do they have the ability to exercise influence is how the presence of significant influence is determined.

The 20% threshold is a guideline only and professional judgment must be exercised in determining if Cornett Chocolates Ltd. has significant influence over Concertina’s Milk Ltd. or not.

Factors will include those listed above. Further, an analysis of the 79.8% holding by other parties is very important. If it is closely held, then the ability for Cornett Chocolates Ltd. to participate is limited and likely cannot significantly influence the financial and operating policies.

WRITING ASSIGNMENT 1-2

|  |  |
| --- | --- |
| Peter (technology & know-how) | 45% of POPP |
| Paul (venture capital company, financing) | 55% of POPP |

How Peter should record its investment in POPP depends on its level of control. They are unlikely to be able to exercise control over POPP, as Paul owns more than 50% of the shares of POPP and is also involved in the business, even though Peter is appointing the managing director and the director of finance.

Paul owns 55% of the shares so would need to assess if they have control of POPP, if this would be considered to be a joint arrangement, or if Peter has significant influence over POPP.

Significant influence is defined as the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies.

Joint control is the contractually agreed sharing of control over an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Paul is providing the financing and owns a majority of the shares. However, as they are a venture capital company it is unlikely that they will be involved on a day to day basis, especially since Peter is contributing the technology and know-how, as well as appointing the managing director and director of finance.

This would not be considered to be a joint arrangement as there seems to be no contractually agreed sharing of control of the arrangement.

Therefore, Peter would have significant influence over POPP and should therefore record its investment in POPP using the equity method.

WRITING ASSIGNMENT 1-3

Godard Inc. sold 60% of its 100% owned Combine Ltd. to Svelte Inc. Godard Inc.’s representatives on the board of directors were replaced by representatives of Svelte Inc. In order to determine if Godard Inc. still has control over Combine Ltd., we must look at and discuss the three criteria that determine if there is control.

(a) *The ability to direct the financial and operating policies of another company (the power criterion)*. This is referred to as the capacity to control. Power arises from rights and these rights must exist presently so that the investor has the current ability to direct relevant activities.

* Godard Inc. no longer owns 60% of Combine Ltd. as it was sold to Svelt Inc. They have retained 40% interest, which is not enough to presume that control exists.
* Godard Inc.’s representatives on the board of directors were replaced with representatives appointed by Svelt Inc. Therefore, Godard Inc. no longer has the ability to direct the financial and operating policies of Combine Ltd.
* Godard Inc. has provided Svelt Inc. with short-term financing and Svelt Inc. has agreed to apply certain operating decisions that Godard Inc. requires as long as the demand loan is outstanding. Godard Inc. can veto any operating decision that is contrary to Godard Inc.’s requirements. As a result, Godard Inc. can influence the financial policies of the company. However, given that it is short-term demand loan , it is unlikely that it is significant to the ongoing operations of the company and unlikely that Godard will control the financial policies of the company.

(b) *The ability to obtain returns from the other company (the returns criterion)*.

* Exposure or rights to returns from an investee. As Godard Inc. still owns 40% of the common shares of Combine Ltd., it can expect to variable returns since the dividend and changes in value of the shares are variable.

(c) *The ability to use its power to affect those returns (the link criterion)*.

* The ability to use power over the investee to affect the amount of the investor’s returns.
* Given that Godard Inc. owns only 40% of the outstanding common shares of Combine Ltd., and the remaining 60% is owned by Svelt Inc., Godard Inc. does not have the ability to affect the returns.

In conclusion, as the power criterion and the link criterion were not met, Godard Inc. no longer has control over Combine Ltd.

WRITING ASSIGNMENT 1-4

The arrangement is a joint operation, formed to facilitate bidding for a public contract that the parties could not bid for individually. Acorn and Magex have retained control of the assets they use to perform the contract requirements and will use their own equipment and employees and are responsible for their respective liabilities. They meet their respective contractual obligations by providing services to Cane.

This would be considered to be a joint arrangement, and Acorn and Magex should recognize in their financial statements their own property, plant, and equipment and operating assets and their share of any liabilities resulting from the joint arrangement (such as performance guarantees). They also recognize the income and expenses associated with providing construction services to Cane.

Acorn and Magex also have an interest in Cane, which should be recognised using the equity method. It is likely that their interests in Cane would be close to zero because Cane does not have any activities other than the contract with the government and the service agreements with Acorn and Magex.

WRITING ASSIGNMENT 1-5

This arrangement involves a joint asset. The joint arrangement is a way to share the costs of having access to an aircraft. Each party has a unilateral right to use the jet aircraft for its own purposes some days each year, and would also have rights to its share of any residual value of the aircraft. It is those rights that the parties control and would recognize in accordance with IFRS 11 and accordingly should report its proportionate share of the asset (the jet aircraft).

WRITING ASSIGNMENT 1-6

The partnership in Shoppers Heaven is a joint venture. The parties have given up their interest in the shopping centre and exchanged it for an interest in the partnership (which has the business form of a separate legal company). The partnership operates as a separate business, generating profit from the shopping centre. The parties cannot sell, pledge or otherwise access directly their share of the shopping centre. They do not have contractual rights to the shopping centre, but have an interest in the partnership (i.e., shares in the separate legal company).

The parties will recognize their interest in the joint arrangement using the equity method.

WRITING ASSIGNMENT 1-7

**Example 1**

If the call options were exercised, Taub would hold 80% of the voting rights of Renwill. Taub has power (control) over Renwill because it holds voting rights of it, together with substantive potential voting rights that give it the current ability to direct its relevant activities.

**Example 2**

If the call options were exercised, Taub would hold 60% of the voting rights of Renwill. Taub has power (control) over Renwill because it holds voting rights of it, together with substantive potential voting rights that give it the current ability to direct its relevant activities.

**Example 3**

If the call options were exercised, Taub would hold 51% of the voting rights of Renwill. Taub has power (control) over Renwill because it holds voting rights of it, together with substantive potential voting rights that give it the current ability to direct its relevant activities.

**Example 4**

If the call options were exercised, Taub would hold all of the voting rights of Renwill. Taub has power (control) over Renwill because it holds voting rights of it, together with substantive potential voting rights that give it the current ability to direct its relevant activities.

WRITING ASSIGNMENT 1-8

|  |  |
| --- | --- |
| Nepean Corp | owns 40% of Osaka Enterprises |
| Warren Inc. | owns 60% of Osaka Enterprises |

Though the options are out of the money, they are currently exercisable and give Nepean Corp. the power to continue to set the operating and financial policies (relevant activities) of Osaka Enterprises, because Nepean Corp. could exercise its options now or at any time and if exercised it would give Nepean Corp. its original 80% ownership interest and voting rights. With the existence of the potential voting rights it would be determined that Nepean Corp. controls Osaka Enterprises.

However, there could be some debate over whether this would be the correct answer, given that:

* Nepean Corp. has not exercised the options as at the statement of financial position date.
* Nepean Corp. may never exercise the options.
* It may not be in Nepean Corp.’s economic interest to exercise the options.
* There may be no parent of Osaka Enterprises.

WRITING ASSIGNMENT 1-9

* Clarence Ltd, Nordahl Corp., and Tweed Inc. each own 1/3 of the common shares of Parenteau Ltée.
* Clarence Ltd. owns all the call options that would give it 100% of the voting rights of Parenteau Ltée.
* Management of Clarence Ltd. does not intend to exercise the options.

According to IFRS 10, with the existence of the potential voting rights, it would be determined that Clarence Ltd. controls Parenteau Ltée. The intention of Clarence Ltd.’s management does not influence the assessment.

However, there can be some debate over whether this is correct.

* Clarence Ltd. has not exercised the options as at the statement of financial position date.
* Clarence Ltd. may never exercise the options.
* It may not be in Clarence Ltd.’s economic interest to exercise the options.
* There may be no parent to Parenteau Ltée.

WRITING ASSIGNMENT 1-10

|  |  |
| --- | --- |
| Daintree | owns 55% of Moor |
| Hong | owns 45% of Moor |

Hong holds convertible debt in Moor that would, on exercise, give it 70% of the voting rights of Moor. However, this would result in a substantial increase in Hong’s debt-equity ratio raising doubts about the company’s capacity to exercise the options.

According to IFRS 10, although the debt instruments are convertible at a substantial price, they are currently convertible and the conversion feature gives Hong the power to set the operating and financial policies of Moor. The existence of the potential voting rights, as well as the other factors described in IFRS 10, would be considered and it is determined that Hong, not Daintree controls Moor. The financial ability of Hong to pay the conversion price does not influence the assessment.

However, there could be some debate over whether this is the correct answer.

* Hong has not at the statement of financial position date exercised the options.
* Hong may never exercise the options.
* It may never be in Hong’s economic interest to exercise the options.

The question of the financial capability of Hong to convert the debt could be considered as follows:

* If exercise would result in a positive economic outcome it is assumed that the holder would be able to arrange financing to enable conversion even if its own resources are not sufficient.
* If a distinction is to be introduced based on the likelihood of conversion rather this determination could be based on whether conversion is economically favourable rather than on the sufficiency of the holder’s resources.

WRITING ASSIGNMENT 1-11

|  |  |
| --- | --- |
| Franklin Inc. | owns 40% of Gould Ltd. |

* Non-controlling interest is 60%
* 65% of the eligible votes are typically cast at the annual general meetings of Gould Ltd.
* There is no other block holding of the shares of Gould Ltd.
* The auditors believe that Gould Ltd. is a subsidiary of Franklin Inc. and the directors of Franklin Inc. believe otherwise

It will be necessary to discuss:

* The concept of control, as if an entity has control over another entity, it is then necessary to prepare consolidated financial statements
* The need to use judgment
* Factors to consider when determining the existence of control:
1. The ability to direct the financial and operating policies of another entity (the power criterion). They own 40%, however there are no other block holdings of shares and only 65% of the non-controlling interest typically votes. This would mean the non-controlling interest accounts for 39% of the votes, which would mean that Franklin Inc. does have the ability to direct the financial and operating policies of Gould Ltd.
2. The ability to obtain returns from the other company (returns criterion).
3. The ability to use its power to affect those returns (link criterion).
* Apply to the above situation
* Expect that Franklin Inc. would be considered to be the parent of Gould Ltd.
* IFRS 10 establishes which entities must prepare consolidated financial statements.

CASES

CASE 1-1

Gunz Inc. is a medium-sized company which is privately owned by the Gunz family. I have been hired to advise on the financial reporting as the sale price may be based on the net asset value of the company. Gunz Inc. has several investments on the statement of financial position and they need to ensure that they are in accordance with the appropriate GAAP.

It first must be determined what are the appropriate accounting standards, as Gunz Inc. could follow accounting standards for private enterprises as they are not a publicly accountable enterprise (ASPE), or they could elect to follow International Financial Reporting Standards (IFRS).

Since the purpose of this report is to analyze and provide advice concerning the investments that Gunz Inc. has on their statement of financial position, I would recommend following IFRS as it provides a consistent basis on which to base the recording of the investments and may provide more information than under ASPE.

**Investments made with Excess Funds**

This was done to earn a higher return than in the bank. The cost was $120,000 and the transaction costs associated with the investments was $1,500 and are currently included in the cost of the investments. The fair market value is currently $150,000. In accordance with IFRS 9, these would be considered to be non-strategic investments and would be recognized initially at cost with any transaction costs immediately expensed. The investments would then be re-valued, on an individual basis if possible, at each subsequent reporting date to fair value with the changes being recognized through net income. As the fair value is currently higher than the cost, it will present a more favourable financial picture for the sale price since it is based on net assets, than if the investments were to be continued to be carried at cost, which is also permissible under ASPE.

CASE 1-1 (Continued)

**Investment in Compoundco.**

This was an investment made during the year for which Gunz Inc. provided $50,000 and in return received an ownership interest of 49%. The other shareholders are children of the original owner and have agreed to sell 10% of the shares each year and are currently not involved in the management of the company.

Does Gunz Inc. have control over Compoundco, in which case it would be required to prepare consolidated financial statements under IFRS, or does it have significant influence in which case it would account for its investment in Compoundco using the equity method?

**Production Facility**

Recognizing the debt associated with the acquisition of the manufacturing plant would not be ideal for Gunz Inc. since it will reduce the net assets, however, it would still have to be recognized if it was determined that it controlled it and would therefore need to consolidate.

The financing was guaranteed by Gunz Inc., all production decisions are taken by Gunz Inc., and all production is sold to Gunz Inc. It would therefore appear that Gunz Inc. has control over this separate corporation and should therefore consolidate. Even under ASPE, it would most probably be necessary to consolidate as it would be considered to be a variable interest entity.

CASE 1-2

**Part 1**

The investment in Rental is controlled jointly by the venturers. The venturers are not liable for any costs of the company.

The venturers each have a direct interest in one floor and an interest in Rental. Rental is a joint venture. It operates as a separate business and the venturers have an interest in the profit generated by the operations of the company. They do not have a present obligation for costs nor do they have rights to the individual assets of the venture (Rental). They each have exchanged their rights to four floors of the building for an interest in the company.

Each partner recognizes its interest in one floor. Each also recognizes its investment in the joint venture, using the equity method.

The joint venture itself (the company) would recognize all of the remaining assets and liabilities of the joint arrangement, including the building (12 floors), furniture, rent receivables, and operating liabilities.

**Part 2**

The venturers each have a direct interest in one floor and an interest in the company (an interest in a joint venture).

The change in the fact pattern (the venturers owned the three floors in the original example, whereas Rental owns the three floors in this variation) does not change the venturers’ rights to use or sublease those three floors. In both situations, the venturers have a contractual right to use or sublease one floor.

Each venture recognizes its interest in one floor in accordance with applicable IFRSs, i.e., IAS 17 *Leases*.

The venturers also recognize their interest in the company using the equity method.

CASE 1-2 (Continued)

**Part 3**

The change in the fact pattern does not change the nature of the joint arrangement, but the interests of the individual venturers are affected. In this case Socre Ltd. has an interest in three floors of the building that it recognizes in accordance with applicable IFRSs. They also recognize its investment in the joint venture using the equity method.

The other two venturers recognize their interest in the company using the equity method.

CASE 1-3

Humphrey Enterprises is a public company located in Toronto, Ontario that follows IFRS and has a December 31 year-end. We will discuss the accounting issues that arose during the current year and their impacts to Humphrey Enterprises. We must take into consideration that Humphrey Enterprises will want to avoid generating a loss in the current year so as to avoid having People’s Commerce Bank’s preferred shares converted to common shares, which would be surrendered by the Humphrey family, thereby diluting their ownership interest and level of control. Although it would only be 5%, bringing their ownership interest potentially down, which would still be likely enough to control Humphrey Enterprises, it may make it more difficult to do so.

**Colin Industries**

This investment was previously accounted for using the equity method, implying that they had significant influence. When using the equity method, Humphrey Enterprises would be directly impacted by the results of Colin Industries. Last year, Colin Industries had a loss and this loss was expected to continue for the foreseeable future. Therefore, Humphrey Enterprises would be exposed to additional losses by accounting for their investment in Colin Industries using the equity method, thereby increasing the risk of People Commerce Bank’s preferred shares being converted to common shares, which is not in the best interest of Humphrey Enterprises and the Humphrey family.

Humphrey Enterprises is now accounting for their investment in Colin Industries at cost. In order for Humphrey Enterprises to change their method of accounting for this investment, there must be a change in circumstance and Humphrey Enterprises would no longer have significant influence over Colin Industries. They are claiming that they no longer have significant influence over Colin Industries due to the chairman of the board of directors resigning at the end of the year in November. It then became increasingly difficult to obtain information from Colin Industries regarding their operations and financial results.

However, Humphrey Enterprises still owns 27% of the outstanding shares of Colin Industries, in addition Humphrey Enterprises has warrants that are convertible into an additional 5% of the outstanding common shares at Humphrey Enterprise’s option. Quantitatively, they hold more than 20% of the shares, therefore according to IAS 28 *Investments in Associates and Joint Ventures* it is presumed that Humphrey Enterprises has significant influence over Colin Industries, unless it can be clearly demonstrated that this is not the case.

CASE 1-3 (Continued)

Although the chairman of the board of directors that was appointed by Humphrey Enterprises resigned during the year and it became increasingly difficult to obtain information from Colin Industries, it does not appear that this is sufficient to demonstrate that there has been a loss of significant influence. Even though the chairman of the board of directors resigned, Humphrey Enterprises still has the ability to appoint the chairman, in addition to still holding three of the ten other seats of the board of directors. Therefore, they would still have the ability to significantly influence the operations of Colin Industries. Humphrey Enterprises would still need to account for their investment in Colin Industries by using the equity method, which would adversely impact their financial statements, as their share of Colin Industries’ losses will be recognized, which is not in accordance with their need to not have a loss in the current fiscal year, for the second year in a row to avoid Peoples Commerce Bank’s preferred shares being converted to common shares.

**Petromax Incorporated**

Humphrey Enterprises acquired 55% as a way to start exclusively distributing Humphrey Enterprises’ products in British Columbia. He does not plan on consolidating with Petromax Incorporated for the first two years subsequent to the acquisition, during the same time that Petromax Incorporated is not expected to be profitable. In doing so, by recording the investment at cost, Humphrey Enterprises’ share of Petromax Incorporated’s losses are not being recorded, thereby helping to avoid generating a net loss which would cause Peoples Commerce Bank’s preferred shares to convert to common shares of Humphrey Enterprises.

If Humphrey Enterprises has control over Petromax Incorporated, then regardless of if it is profitable or not, they must consolidate with Petromax Incorporated. In doing so, the financial results of Petromax Incorporated would be included with those of Humphrey Enterprises on a line-by-line basis. Therefore, they would be exposed and adversely impacted by the losses Petromax Incorporated is expected to incur for the next two years.

It would appear that Humphrey Enterprises has control over Petromax Incorporated, as Humphrey Enterprises owns 55% of the shares of Petromax, therefore control is presumed to exist. In addition, Petromax Incorporated will start to exclusively sell Humphrey Enterprise’s products. Humphrey Enterprises has the power to govern the financial and operating policies of Petromax Incorporated so as to obtain the benefits from its activities. Humphrey Enterprises also planned on starting to consolidate in two years, when Petromax Incorporated is expected to become profitable, which also indicates that Humphrey Enterprises believes they have controls over them.

CASE 1-3 (Continued)

Humphrey Enterprises has obtained control over Petromax Incorporated during the year, and so a business combination has occurred. Will have to account for it using the acquisition method and recognize the acquisition date fair value of the identifiable assets and liabilities acquired, and any goodwill or gain from bargain purchase. Humphrey Enterprises will consolidate with Petromax Incorporated as of the date of acquisition. Therefore, Humphrey Enterprises will recognize Petromax Incorporated’s expected losses, which is not in accordance with their need to avoid generating a loss this year.

**Sasha Ltd.**

Have accounted for this investment in the past at fair value with the gains and losses recognized through profit or loss and in the current year began to account for it by recognizing the gains or losses through other comprehensive income. It is normally not appropriate to change the designation, unless there has been a change in circumstance.

During the year the fair market value of Humphrey Enterprise’s investment in Sasha Ltd. declined, which Humphrey Enterprises would have had to recognize if the investment’s fair value changes were still being recognized through profit or loss. By recording the fair values changes in other comprehensive income, this could be beneficial to Humphrey Enterprises to avoid generating a loss for the second year and having People’s Commerce Bank’s preferred shares being converted to common shares.

However, according to IFRS 9 *Financial Instruments*, when, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets. In addition, after initial recognition, Humphrey Enterprises should measure financial assets at fair value with their gains or losses recognized in profit or loss unless it is an investment in an equity instrument and the entity has elected to present gains or losses on that investment in other comprehensive income. At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not considered held for trading. However, since this investment was not designated at initial recognition and it is also unlikely that the investment would not be considered to be held for trading.

CASE 1-3 (Continued)

Therefore, I would recommend that Humphrey Enterprises account for their investment in Sasha Ltd. as fair value through profit or loss, and to recognize the loss in net income, contrary to their need to avoid a loss in the current year. Furthermore, even if it is not accounted for as fair value through profit or loss and it is continued to be accounted for as available for sale, if the investment in Sasha Ltd. was impaired, Humphrey Enterprises would still have to recognize the impairment loss in net income in the current year.

In addition, with the introduction of IFRS 9 *Financial Instruments*, all investments will have to be accounted for at fair value with the changes in net income or they could elect to recognize the changes in accumulated other comprehensive income.

**Conclusion**

Overall, it appears that Humphrey Enterprises has made aggressive accounting policy choices for these three investments and in doing so helped to minimize their chance of generating a loss in the current year, for the second consecutive year and avoid People’s Commerce Bank’s preferred shares being converted to common shares and the Humphrey family’s ownership level and level of control being diluted.

Will need to obtain the financial results of Humphrey Enterprises and of the investments in question to determine the exact financial impact on Humphrey Enterprises and if they will in fact have a loss for the second consecutive year.

CASE 1-4

This is a memo to Mr. Potter from the in-charge accountant of the engagement that discusses the significant accounting issues for the engagement. It will present a review of the accounting issues associated with each specific investment held by Jackson Capital Inc., as well as with the long-term debt issued by Jackson Capital Inc. and its share capital.

Jackson Capital Inc.’s investments are all forms of financial instruments. Jackson Capital Inc.’s business mission is to support companies to allow them to compete successfully in domestic and international markets. Jackson Capital Inc. aims to increase the value of its investments, thereby creating wealth for its shareholders. Over the past year, Jackson Capital Inc. has accumulated a diversified investment portfolio. Depending on the needs of the borrower, Jackson Capital Inc. provides capital in many different forms, including demand loans, short-term equity investments, fixed-term loans, and loans convertible into share capital. Jackson Capital Inc. also purchases preferred and common shares in new business ventures where Jackson Capital Inc. management anticipates a significant return. Any excess funds not committed to a particular investment are held temporarily in money market funds.

Normally when looking at equity investments we would look at IAS 28 for investments in associates, or IFRS 11 for joint arrangements. However, these standards do not apply to investments in associates held by venture capital organizations, as these types of companies are specifically scoped out.

e.g., IAS 28 states “…that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IFRS 9 *Financial Instruments*. Such investments shall be measured at fair value in accordance with IFRS 9, with changes in fair value recognised in profit or loss in the period of the change”.

Therefore, we need to look to IFRS 9 for the treatment of the investments, where companies must classify their investments in equity instruments at fair value through profit and loss. All equity instruments are recorded at fair value, even if a market for it does not exist. The irrevocable election would not be applicable in this instance as Jackson Capital Inc.’s investments are held for trading as they are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern.

We will address these issues as they relate specifically to each investment below.

CASE 1-4 (Continued)

**Investment in Fairex Resource Inc.**

Jackson Capital Inc. holds 15% of Fairex Resource Inc., a company listed on the TSX Venture Exchange. We have been told that the company’s intent is to hold this investment for the next 6 months and then decide whether to sell or hold again. JCI has indicated that it is not being held as a strategic investment for a long period of time. The investment will be accounted for as a financial instrument under IFRS 9, specifically as a financial asset (it is an equity instrument in another entity).

This investment is an equity investment that is traded on the TSX Venture Exchange. Consequently, there is a quoted market value for this investment. JCI intends to hold the investment for only 6 months and to make a buy or hold decision at that time. Since it is an equity investment, it will be measured using FVTPL.

The investment must be recorded at fair value at each reporting date and the unrealized gain or loss will be recorded directly to the profit or loss for the year.

Dividends received on this investment would be recorded in profit or loss under either classification.

The basis of accounting must be disclosed. This investment should be recorded as short term since the intent is to sell in the next 6 months.

**Investment in Hellon Ltd.**

In this case, there are two investments – the first is an equity investment and the second is a debt instrument. We will look at the equity investment first.

JCI holds a 25% interest in the common shares of Hellon Ltd., a private Canadian real estate company. JCI likely exercises significant influence over Hellon Ltd. due to the size of its investment (greater than 20%). The conversion feature on the debentures held also contributes to JCI’s exercising significant influence and possibly to control. We should find out how long JCI has held the investment in Hellon to ensure that it actually forms part of the investment portfolio, and is not a separate, longer-term investment.

Since JCI exercises significant influence over Hellon Ltd., then under IAS 28, it should account for the investment under the equity method described above. If JCI has control over Hellon, taking into account the convertible nature of the bond, Hellon’s results should be consolidated with JCI’s results. Under IAS 28, Hellon is referred to as an “Associate”.

CASE 1-4 (Continued)

Assuming that there is only significant influence, under IAS 28, the investment would be initially recorded at cost; JCI’s share of Hellon’s net income would be recorded as investment income and would increase the value of the investment on the statement of financial position. Any dividends paid by Hellon would decrease the value of the investment on the statement of financial position. In using this method, the purchase price must first be allocated to the fair value of the associate’s identifiable assets, and to goodwill. This will provide any fair value increments that must be amortized in subsequent years as the assets are used or liabilities settled. In addition, each year, the investor’s portion of profits and losses arising on intercompany transactions (downstream and upstream transactions) must be eliminated through the investment income and investment account.

The debentures are a financial asset. Under IFRS 9 *Financial Instruments*, this investment would also be recorded at amortized cost as opposed to FVTPL, as both of the following conditions are met:

(a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Assuming that JCI will record the debentures at amortized cost, the debentures should be recorded at $1,96 million (98% of $2 million). The effective interest rate will be used to amortize the debt and interest income reported in the profit or loss statement. JCI should also accrue any interest receivable on the debentures at June 30, 2013.

The debentures should be reported as long term.

The basis of valuation of the investment should be disclosed. The terms of the debentures should also be disclosed. The investment should also be tested for impairment at the year-end.

CASE 1-4 (Continued)

# Loan to Ipanema

JCI holds a five-year loan to Ipanema Ltd., a Brazilian company; 75% of the loan is secured by a power generating station under construction. The loan is denominated in Brazilian reals.

It is likely, that following the same analysis above for Hellon, this investment should be recognized at amortized cost since there does not appear to be an active market for it, and the loan has fixed and determinable payments and their business model is to collect the contractual cash flows associated with this loan. The loan would initially be recorded at fair value, and then amortized using the effective interest rate method. Interest income would be reported in the profit or loss for the year.

At the year end, we need to assess whether the loan is impaired (in accordance with IFRS 9), due to two factors: the possible instability of the Brazilian currency and the risk that Brazil will impose currency restrictions, as well as the non-portability of the security for the loan. If the loan is impaired, the carrying amount of the loan should be reduced. The reduction in the carrying amount would be recognized as a charge in the current financial statements. In this case, because the investment is carried at cost, the impairment cannot be reversed in subsequent years.

The loan should be translated at the exchange rate at the statement of financial position date (IAS 21 *The Effects of Changes in Foreign Exchange Rates*). This restatement will result in an exchange gain or loss through the income statement. An exchange gain or loss will be taken to the income statement at each statement of financial position date. These gains or losses could create a great deal of volatility in the income statement if the Brazilian real fluctuates against the Canadian dollar. We should also consider if Brazil’s economy could be considered hyperinflationary. If so, then IAS 29 *Financial Reporting in Hyperinflationary Economies* should be applied.

JCI should disclose the terms of the loan, the security, and the foreign exchange gain or loss, as well as the currency of the loan.

CASE 1-4 (Continued)

**Interest in Western Gas**

JCI has a 50% interest in Western Gas, a gas exploration business in Western Canada. The 50% interest level suggests that this investment is a joint venture.

We will need to assess if joint control exists. Joint control exists where, by contract, unanimous consent is required by all venturers on financial and operating decisions. Joint control may not exist, however, since JCI has only one member of a three-member board. Despite this fact, if board decisions require unanimous consent, JCI may still have joint control, through its effective power of veto. We should scrutinize the venture agreement to properly assess the control exercised by JCI and decide on the appropriate accounting treatment for this investment. IFRS 11 *Joint Arrangements* identifies two types of joint control: joint ventures and joint operations. We would have to look at the nature of the agreement to specifically identify the nature of this joint ownership and the rights and obligations in the normal course of business that the two investors have.

The following are the two alternatives available under IFRS 11:

1. Joint Operations — The investor has a contractual right or obligation to the assets and liabilities of the operation. A joint arrangement that is not structured as a separate entity is a joint operation. However, a separate entity could still be a joint operation. A joint operation is usually a joint arrangement that involves the use of the assets and other resources of the parties.
2. Joint Ventures — It must be set up as a separate vehicle. An investor is party to a joint venture when it does not have the right to the assets or the obligations for the liabilities. Its rights are only to a share of the outcome generated by a group of assets and liabilities carrying on an economic activity and they do not have rights to individual assets or obligations of the venture, only to the net assets.

Assuming that JCI has joint control in a separate entity, then there are two alternatives for recording this investment:

1. Joint Ventures — Equity method – where the investment in Western Gas would be recorded at cost initially, and then each reporting period, 50% of the profit or loss of Western Gas would be added to JCI’s income and investment account. This would be used if it is considered to be a joint venture investment.

In the case of JCI, the equity method might be more informative, since the company has a variety of investments. Note that there is a proposal to eliminate the proportionate consolidation method as an option (see exposure draft for more details).

CASE 1-4 (Continued)

1. Joint Operations — They will report their share of each asset and liability, revenue or expense that it owns.

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

**Tornado Hydrocarbons Ltd.**

JCI has 50,000 stock warrants in Tornado Hydrocarbons Ltd., expiring March 22, 2015. The underlying common shares trade publicly.

Under IFRS 9 *Financial Instruments*, this investment would be recorded at FVTPL. Since the underlying shares are publicly traded, then a fair value can be reasonably determined at each reporting period end date.

**Stock-indexed bond payable**

On March 1, 2013, JCI issued long-term, 5%, stock-indexed bonds payable for $6 million. This bond, the principal repayment of which is indexed to the TSX Composite, bears the risk that the principal repayment will increase or decrease due to factors beyond the control of management. This factor makes valuation a key issue for this bond.

Under IFRS 9, a financial liability can be recognized as either FVTPL or at amortized cost. For the designation of FVTPL, it must be held for trading, If FVTPL is chosen, the liability is recorded at fair value at each reporting period and unrealized gains and losses are recorded in profit and loss. Interest paid on the loan would also be recorded in the profit and loss for the year. JCI would value the bond based on the index at each reporting date. This method provides the best estimate of the liability at the reporting date. This method does not, however, capture the final amount that will be paid at maturity. Immediate recognition of unrealized gains and losses reflects the risk of the instrument.

The second alternative is to record the stock indexed bonds payable as a loan that is recorded initially at fair value, and then at amortized cost using the effective interest rate method until maturity. The effective interest amount would be shown as an expense in the profit and loss. This valuation method would eliminate any earnings fluctuations due to revaluations caused by factors unrelated to the business. This method would not, however, reflect the amount payable at the statement of financial position date.

CASE 1-4 (Continued)

JCI should disclose the interest rate, maturity date, amount outstanding, and the terms of the debt in the notes to the financial statements, and the fair value of the debt if the FVTPL is not used.

**Share capital**

JCI’s share capital consists of 1 million 8% Class A (non-voting) shares redeemable at the holder’s option on or after August 10, 2017. These Class A shares have some characteristics of a liability instrument (the holder has the right to require the issuer to redeem the share), even if the legal form is equity. Under IAS 32, the substance of the transaction takes precedence over its legal form. IAS 32, paragraph AG25, states that a preference share that provides for redemption at the holder’s option would be a financial liability. In this case, the Class A shares should be recorded as a liability. The dividends paid on these shares should be recorded in the statement of profit or loss.

The characteristics of the Class A shares should be disclosed.

**Management Bonuses**

It is stated that the management bonuses are calculated based on the returns on the investments. A key question here is whether unrealized gains and losses are included in these calculations. This will have to be discussed with JCI.

CASE 1-5

Lachlan Corp. established Serouya Ltd.

• Lachlan holds all the convertible debentures of Serouya

• Mr. Jiang is the 100% owner of the shares of Serouya

In order to determine if Serouya Ltd. is a subsidiary of Lachlan, Corp., we must determine if Lachlan Corp. is a parent of Serouya Ltd.,and if Lachlan Corp. controls Serouya Ltd. We must consider the definition of control as defined in IFRS 10 *Consolidated Financial Statements*.

As Lachlan Corp. holds convertible debentures, does this give it control over Serouya Ltd.?

Mr. Jiang actually controls Serouya Ltd., but the IASB concept of control is a capacity to control, a power to govern concept rather than an actual control concept.

Lachlan Corp. can be considered a passive controller as the holder of a presently exercisable instrument has the capacity to control Lachlan Corp. has the unilateral ability to exercise the instrument and thus obtain the power to determine financial and operating policy.

By not exercising the conversion option, Lachlan Corp. is implicitly accepting the policy determinations of Serouya Ltd. An analogy can be drawn with delegated authority. Mr. Jiang knows that if he fails to gain the approval of Lachlan Corp. for his actions, then the latter can exercise control by converting the debentures.

The instrument must be currently exercisable for Lachlan Corp. to be considered to have control of Serouya Ltd.

An alternative position is that Mr. Jiang controls until Lachlan Corp. actually chooses to exercise the conversion option. Lachlan Corp. cannot actually make any policy decisions in relation to Serouya Ltd. It must first exercise all the conversion options. It may decide to exercise the options, or it may decide to never exercise that option. In that case, Mr. Jiang determines all the policies in relation to Serouya Ltd., Mr. Jiang has current capacity to control; this would change if Lachlan Corp. exercises its options. But until it takes that step, it does not have the current capacity to control. Given that Lachlan Corp. has not exercised the option, do the shareholders in Lachlan Corp. want or need information about the combined entity of the two companies?

CASE 1-5 (Continued)

A further point of discussion is whether the likelihood of exercise of the conversion option should be part of the decision process.

A further point of discussion is whether if because of economic conditions, Lachlan Corp. would not exercise the options. If it is detrimental to the holder of the option to exercise them, can the holder be considered to have control over the other entity?

CASE 1-6

Endeavour Films owns 41% Barco Ltd., while the remaining 59% is widely held.

In order to determine if Endeavour Films should consolidate Barco Ltd., they must look at whether they have control of Barco Ltd. or not. If so, then they need to consolidate and if they do not have control of Barco Ltd. Then they do not consolidate Barco Ltd.

1. If the non-controlling interest is widely held then it may be argued that Endeavour Films has the capacity to control Barco Ltd. Based on the potential for the non-controlling interest to outvote Endeavour Films in determining the directors of Barco Ltd.

However, other factors should also be considered, such as:

* Historical attendance at the annual general meetings of Barco Ltd.
* If there is a presence of interest groups within non-controlling interest
* Geographical distribution of the non-controlling interest

If the non-controlling interest were tightly held would be the decision be any different?

The other key factor in the definition is the benefit criterion. A parent must have the capacity to benefit from the control that they exercise.

In this case, many of the key policy decisions seem to have been set by a contract:

* Must purchase 90% of their television shows from Endeavour Films as determined by Endeavour Films
* The terms & conditions of supply are determined by Endeavour Films
* There are limited rights to engage in other businesses
* Endeavour Films provides marketing services to Barco Ltd.
* Barco Ltd. Leases rental space from Endeavour Films

Therefore, even if the non-controlling interest could dominate the board of directors of Barco Ltd., there is not much they can change to increase or modify their benefits. Endeavour Films is therefore running the business and the non-controlling interest are simply investors.

1. Whether the ownership of Barco Ltd.’s shares comes from acquisition on the open market or acquisition at incorporation of the company is not of interest as it has no effect on the determination of control.

CASE 1-7

|  |  |  |
| --- | --- | --- |
| Logan Ltd. | owns 35% of Murray Inc. |  |
| Logan Ltd. | owns 40% of Jarislowsky Corp. | owns 17% of Murray Inc. |

1. In order to determine if Logan Ltd. controls Jarislowsky Corp. and/or Murray Inc., must consider the definition of control.

The power to govern or the capacity to control depends on an entity having the ability to direct the policies of another entity so as to benefit from it and to be able to use that power to increase those benefits.

The determination of control requires judgment. The ability to exert control depends on factors such as:

* The size of the voting interest
* The dispersion of the other shareholdings
* The level of disorganization or apathy of the non-controlling shareholders
* The attendance levels at the annual general meetings
* Contractual arrangements
* Arrangements between friendly parties

Applying these to the above example, it would be expected that Jarislowsky Corp. is a subsidiary of Logan Ltd. and if Jarislowsky Corp. is a subsidiary, then Murray Inc. is also a subsidiary, and, as such, Logan Ltd. would control 52% of the vote.

1. A change in the relative ownerships within Jarislowsky Corp. would suggest that, dependent on other factors, it would lose subsidiary status. Murray Inc. would also then lose its subsidiary status.

CASE 1-8

|  |  |
| --- | --- |
| Ord Inc. | owns 40% of Derwent Co. (the only substantial shareholding in the company) |

* The non-controlling interest is 60%.
* No other party holds >3% interest in Derwent Co.
* Only 75% attendance at the annual general meeting last year.

In order for Derwent Co. to be classified as a subsidiary of Ord Inc., it will be necessary to discuss the following:

* The concept of control, as if an entity has control over another entity, it is then necessary to prepare consolidated financial statements.
* The need to use judgment.
* Factors to consider when determining the existence of control

1. The ability to direct the financial and operating policies of another entity (the power criterion). They own 40%, however there are no other block holdings.

2. The ability to obtain returns from the other company (the returns criterion).

3. The ability to use its power to affect those returns (the link criterion).

* Apply to the above situation

After such a discussion, we would expect that Ord Inc. will be the parent of Derwent Co.

Consider:

* The difference between actual control and the capacity to control; the party actually controlling the other entity may not have the capacity to control. Just because Ord Inc.’s nominees are elected as board members does not automatically mean that it becomes the parent of Derwent Co. It simply means that it actually controls that entity. The question is whether it has the capacity to control.
* If holders of 90% of the voting shares attended the annual general meeting, then holders of 50% of the shares could have outvoted Ord Inc. They may allow Ord Inc. to manage Derwent Co. because of the great managerial skills or business connections of Ord. Inc. In this case, Ord Inc. is not the parent of Derwent Co.
* The purpose of consolidation — If Ord Inc. is actually controlling Derwent Co., even though it does not have the capacity to control, would the shareholders of Ord Inc. be interested in a set of consolidated financial statements for the combined group? Does the issue of accountability provide sufficient grounds for the consolidation of the two entities?

CASE 1-9

Polka Dot Enterprises has recently begun the necessary steps to going public in the near future and I have been engaged to help with all the requirements as part of the process of going public. Management of Polka Dot Enterprises specifically would like to have the statement of financial position and extracts of the notes to the financial statements reviewed and commented on.

The chief financial officer is particularly concerned with the accounting of the investments that Polka Dot Enterprises has (which is what the extracts of the notes to the financial statements concerns.

They have stated that it is not necessary to re-state the statement of financial position, but rather to simply discuss and explain any changes required in the accounting for the investments and to explain the impact that it would have on Polka Dot Enterprises. Therefore, this is what will be performed.

Polka Dot Enterprises presently has four investments per their statement of financial position and they are all accounted for using the cost method. Under IFRS, except with very limited exceptions, the cost method should not be used and the basis of accounting will depend on the nature of the investment.

**Investment in Ranger Limited**

The cost was $121,736. The investment was made during the year to invest excess cash on hand to purchase 4% of the outstanding shares of Ranger Limited. Polka Dot Enterprises is also planning on selling the shares in the short-term when the cash is needed. This investment would be considered to be a non-strategic investment was it was made for short-term purposes and to invest excess cash. As they own 4% of the shares of Ranger Limited, there is a presumption that it is not a strategic investment and there are no other indicators that would indicate otherwise.

The investment should therefore be recorded at its fair value and not at its cost, with the changes being recorded through net income (unless the irrevocable election is made to record the changes through other comprehensive income). In this case, the fair value of Ranger Limited is presently higher than its recorded cost amount at $156,212. Therefore, the difference of $34,476 ($156,212 – $121,736) will be recognized by Polka Dot Enterprises and will increase their net income. If the irrevocable election was made, it would be recorded in other comprehensive income instead of net income.

Polka Dot Enterprises has also recorded dividend income of $71,212 which is correct, as the dividend received is recorded through income in the year the company is entitled to it.

CASE 1-9 (Continued)

**Investment in Tulip Inc.**

Polka Dot Enterprises purchased 100% of Tulip Inc. for $102,911. They can also appoint three of the four board of director’s positions. It appears that Polka Dot Enterprises has control over Tulip Inc. as they have the ability to direct the financial and operating policies of Tulip Inc. as they own 100% of the shares and they can appoint three of the four board of director’s position. They also have the ability to obtain returns from Tulip Inc. and have the ability to use its power to affect those returns.

Therefore, it will be necessary for Polka Dot Enterprises to present consolidated financial statements with Tulip Inc. The investment account in Tulip Inc. will be eliminated on Polka Dot Enterprises financial statements and replaced on a line-by-line basis with each asset and liability of the subsidiary, Tulip Inc. Also, each item of income and expense will be combined so it would not be correct for Polka Dot Enterprises to recognize the dividend income, but rather they should recognize the net income of Tulip Inc. of $120,921. This will be favourable to their financial statements as this year it was net income that Tulip Inc. had, however in years of reduced net income or net loss it could adversely affect the financial statements of Polka Dot Enterprises.

**Shoes Enterprise**

Polka Dot Enterprises obtained a 19% interest in Shoes Enterprise, in addition to gaining access to a supplier, as prior to this Shoes Enterprise was a main supplier of Polka Dot Enterprises. This investment is being carried at cost, however it appears that this investment is one of significant influence in which case it should be accounted for using the equity method. They would have significant influence even if they own less than 20% of Shoes Enterprise, as they appear to have the power to participate in the financial and operating policy decisions of Shoes Enterprise given that it is a major supplier, but it is not control or joint control over those policies. As they are a main supplier to Polka Dot Enterprises there are material transactions between the two companies.

The investment will be recorded using the equity method as follows. The initial investment in Shoes Enterprise is recorded at cost and then Polka Dot Enterprises share of the profit or loss of Shoes Enterprise (19%) is recognized subsequent to acquisition. This would be 19% of $137,934 and the dividend income that was originally recorded as income would actually serve to reduce the investment in Shoes Enterprise, as opposed to recognizing it as income. This year as income of Shoes Enterprise was favourable, it will result in better results to Polka Dot Enterprises. However, if Shoes Enterprise was to recognize a loss it would directly impact the financial results of Polka Dot Enterprises in a negative way.

CASE 1-9 (Continued)

**Rose Limited**

This would be considered to be a joint arrangement as there is joint control and the contractually agreed sharing of control over Rose Limited. This exists when decisions about the relevant activities require unanimous consent of the parties sharing control. In this case, no major decisions concerning Rose Limited can be made without the consent of both parties, which shows the presence of joint control. It would be considered to be a joint venture and not a joint operation as it was set up as a separate vehicle and it appears that neither party has the rights to the assets or obligations for the liabilities of Rose Limited, and each party will share equally in the profits of Rose Limited.

The investment will be recorded using the equity method as follows. The initial investment in Rose Limited is recorded at cost and then Polka Dot Enterprises share of the profit or loss of Rose Limited (50%) is recognized subsequent to acquisition. This would be 50% of $201,692 and the dividend income that was originally recorded as income would actually serve to reduce the investment in Rose Limited, as opposed to recognizing it as income. This year as income of Rose Limited was favourable, it will result in better results to Polka Dot Enterprises. However, if Rose Limited was to recognize a loss it would directly impact the financial results of Polka Dot Enterprises in a negative way.

**Overall Conclusion**

As follows, I have restated the net income of Polka Dot Enterprises (excluding tax considerations for the components of investment income), and it is different when the investments are measured and recorded correctly under IFRS.

|  |  |
| --- | --- |
| Polka Dot Enterprises net income as originally stated | $315,665 |
| Investment in Ranger Limited – increase in FMV | $34,476 |
| Investment in Tulip Inc. – net income consolidation | $120,921 |
| Investment in Tulip Inc. – remove dividends from net income | ($48,467) |
| Investment in Shoes Enterprise – remove dividends from net income | ($24,921) |
| Investment in Shoes Enterprise – equity method pickup of share of net income (19% × $137,934) | $26,207 |
| Investment in Rose Limited – remove dividends from net income | ($34,539) |
| Investment in Rose Limited – equity method pickup of share of net income (50% × $201,692) |  $100,846 |
| Restated net income of Polka Dot Enterprises |  $490,188 |