

Chapter 13

- Significant % of ownership → can control
- investing & not control → not intervene the invested firm

INTERCORPORATE INVESTMENTS

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CONTENTS

1. Introduction
2. Basic Corporate Investment Categories
3. Investments in Financial Assets: IFRS 9
4. Investments in Associates and Joint Ventures
5. Business Combinations
6. Summary

LEARNING OUTCOMES

- describe the classification, measurement, and disclosure under International Financial Reporting Standards (IFRS) for 1) investments in financial assets, 2) investments in associates, 3) joint ventures, and 4) business combinations;
- distinguish between IFRS and US GAAP in the classification, measurement, and disclosure of investments in financial assets, investments in associates, joint ventures, and business combinations;

INTERCORPORATE INVESTMENTS

- **Intercorporate investments (investments in other companies)** include investments in the debt and equity securities of other companies.
- **Reasons for investing in other companies:**
 - To achieve additional profitability.
 - To enter new markets through companies established in those areas.
 - To diversify.
 - To obtain competitive advantages.
- The classification of intercorporate investments is based on *the degree of influence or control* that the investor is able to exercise over the investee.

CLASSIFYING INTERCORPORATE INVESTMENTS

Investments are classified into four categories based on the *degree of influence or control*:

- Investments in **financial assets** (ownership percentage < 20%): Investments in which the investor **has no significant control** over the investee.
- Investments in **associates** (ownership percentage between 20% and 50%): Investments in which the investor **has significant influence but not control** over the investee.
- **Business combinations** (ownership percentage > 50%): Investments in which the investor **has control** over the investee.
- **Joint venture**: an entity operated by companies that **share control**.
- In practice, ownership percentage is flexible.

SUMMARY OF ACCOUNTING TREATMENTS FOR INVESTMENTS

e.g. Special project

	In Financial Assets	In Associates	Business Combinations	In Joint Ventures
Influence	Not significant	Significant	Controlling	Shared control
Typical percentage interest	Usually < 20%	Usually 20% to 50%	Usually > 50% or other indications of control	major shdr has control
US GAAP ^b	FASB ASC Topic 320 <i>investment in private firm</i>	FASB ASC Topic 323	FASB ASC Topics 805 and 810	FASB ASC Topic 323
Financial Reporting FVTPL FVOCI	Classified as: <i>fair price</i> <ul style="list-style-type: none"> • Fair value through profit or loss • Fair value through other comprehensive income • Amortized cost <i>only debt</i> 	Equity method <i>earn proportionate of what we can control</i>	Consolidation <i>combine all numbers from subsidiaries as single firm</i>	IFRS: Equity method
Applicable IFRS ^a	IFRS 9	IAS 28	IAS 27 IFRS 3 IFRS 10	IFRS 11 IFRS 12 IAS 28
US GAAP ^b	FASB ASC Topic 320	FASB ASC Topic 323	FASB ASC Topics 805 and 810	FASB ASC Topic 323

ACCOUNTING FOR INVESTMENTS IN FINANCIAL ASSETS



- IFRS 9 became effective for annual periods commencing on 1 January 2018.
 - US GAAP equivalent is in ASV 825 but many inconsistencies with IFRS 9.
 - IFRS 9 does not use a portfolio approach and 'available-for-sale' and 'held-to-maturity' classification does not appear in IFRS 9).
-
- All financial assets are measured at fair value when initially acquired.
 - Subsequently, financial assets are measured at either fair value or amortized cost.
 - Criteria for using '**amortized cost**' is similar to previous IAS 39 but financial assets must meet two criteria:
 - 1) **Business model test** (the financial assets are being held to collect contractual cash flow); and
 - 2) **Cash flow characteristic test** (The contractual cash flows are solely payments of principal and interest on principal).
- hold until the end of contract!!
only investment in debt*

ACCOUNTING FOR INVESTMENTS IN FINANCIAL ASSETS

- IFRS 9 classifies all financial assets into those measured:
 - At amortized cost; and inv in debt fair value amortized cost
 - At fair value. inv in equity can be only fair value
- There are three different categories of measurement:
 - Amortized cost
 - Fair value through profit or loss (FVPL)
 - Fair value through other comprehensive income (FVOCI)

DEBT INVESTMENT

Illustration 17.2 identifies these categories, along with the accounting and reporting treatments required for each.

Category	Valuation	Unrealized Gains or Losses	Other Income
Held-for-collection <i>hold to collect cash until maturity</i>	Amortized cost	Not recognized <i>not part of strategy fluctuate & don't have control</i> <i>unrealized gain/loss</i>	Interest when earned; gains and losses from sale. <i>generally don't do it</i>
Held-for-collection and selling <i>unclear has probability to sell it</i>	Fair value <i>If firm sell this bond, how much will they get</i>	Recognized as other comprehensive income and as a separate component of equity <i>unrealized gain/loss</i>	Interest when earned; gains and losses from sale.
Trading securities	Fair value	Recognized in net income in P/L <i>in part of firm strategy</i>	Interest when earned; gains and losses from sale.

ILLUSTRATION 17.2 Accounting for Debt Investments by Category

Source: Keiso, Weygandt, and Warfield "Intermediate Accounting: IFRS Edition"

In view of investor:

(1)

DEBT INVESTMENT-AMORTIZED COST

- Investors: Principal = \$1,000; Coupon interest rate = 10%, paid annually; Maturity = 5 years. Return the market demands on the bond on the day we are valuing it = 8%. Issued at 108 (i.e., 108% of face value).
- At issuance, cash paid for debt investment of \$1080

price (premium)

Transaction	Year	Assets =		Liabilities	Owners' Equity		CFO : US GAAP CFO or CPI CIFRS
		Cash	Debt Investment		Common Stock	Net Inc. to Ret. Earnings	
Initial investment	Begin 1	pay cash -1,080	get this 1,080				Interest revenue
Receive cash interest	1	+100	Fixed based on coupon amortize -14 \Rightarrow = 1066	1080 - 14 $87 \times 1080 = +86$			
Receive cash interest	2	+100	-15 \Rightarrow = 1051				
Receive cash interest	3	+100	-16				
Receive cash interest	4	+100	-17				
Receive cash interest	5	+100	-19				
Receive principal	5	+1,000	-1,000				

DEBT INVESTMENT-FAIR VALUE

Transaction	Year	Assets =		Liabilities	Owners' Equity		
		Cash	Debt Investment		Common Stock	Net Inc. to Ret. Earnings	
Initial investment	Begin 1	-1,080	1,080				
Receive cash interest	1	+100	amortize debt -14 $\Rightarrow 1066$ before adjust for fair value assume fair value (from bond mkt) $FV(1) = 1060$ value drop by \$6 \Rightarrow unrealized loss -6		EIR or mkt rate +86	Interest revenue -6	Interest revenue Unrealized loss on FV adjustment
Receive cash interest	2	+100	-15 once a yr * semi-annually ~ amortize 2 times a yr but valuation adjustment only		coupon payment +85 , nominal fair value once a year nominal amount	Interest revenue +10	Interest revenue Unrealized gain on FV adjustment

- FV (End of Y1) = 1,060; Carrying amount (before adjust FV) = 1,080-14 = 1,066
- Unrealized loss = 1060 – 1066 = -6
- FV (End of Y2) = 1,055; Carrying amount (before adjust FV) = 1,060-15 = 1,045
- Unrealized gain = 1055-1045 = +10

EQUITY INVESTMENT

Category	Valuation	Unrealized Holding Gains or Losses	Other Income Effects
Holdings less than 20%			
1. Trading	Fair value	Recognized in net income	Dividends declared; gains and losses from sale.
2. Non-Trading Option	Fair value	Recognized in “Other comprehensive income” and as separate component of equity	Dividends declared; gains and losses from sale.

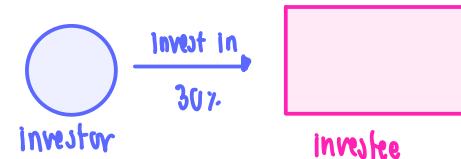
Source: Keiso, Weygandt, and Warfield “Intermediate Accounting: IFRS Edition”

RECLASSIFICATION OF INVESTMENTS IN FINANCIAL ASSETS

- The reclassification of equity investments is not permitted.
 - The choice to measure equity investments at FVOCI or FVPL is irrevocable.
- The reclassification of debt investments is only permitted if the business model for the financial assets (objective for holding the financial assets) has changed in a way that significantly affects operations. *must tell reason*
 - When reclassification is deemed appropriate, there is no restatement of prior periods at the reclassification date.
- Analysts typically evaluate performance separately for operating and investing activities.
- Analysis of operating performance should exclude items related to investing activities such as interest income, dividends, and realized and unrealized gains and losses.
- For comparative purposes, analysts should exclude non-operating assets in the determination of return on net operating assets.
- Using market values and adjusting pro forma financial statements for consistency improves assessments of performance ratios across companies.

ACCOUNTING FOR INVESTMENTS IN ASSOCIATES

- The **equity method** is used to account for **investments in associates**.
- To qualify, a company must have significant influence over the investee.
Significant influence is presumed with 20–50% ownership, but exceptions can be made based on other indicators of influence, including:
even ownership < 20%.
 - Representation on the board of directors
 - Participation in policymaking
 - Material transactions between companies
 - Interchange of management
send someone to another company and vice versa
 - Technological dependency
- Because of this influence, it is presumed that *the investee's income is at least partially attributed to the influence of the investor*. As such, the investor recognizes a **proportionate amount of investee's income**.



- If investee grow larger as they earn income investor will also grows larger based on proportion they invest in

EQUITY METHOD

e.g. pay \$1 mm for 30% of investee

↑ will grow bigger / smaller
depends on operation
changes in net assets

- Initially record the investment at cost. Subsequently, adjust the amount each period for changes in investee's net assets.
 - Investor's proportionate share of the earnings (losses) of the investee increases (decreases) the investment's carrying amount.
 - Dividends received from the investee decrease the investment's carrying amount.
↳ dividend → distribute profit → equity ↓ → investment in this firm ↓
IF doesn't declare dividend → still the same equity
- The investment is classified as noncurrent on the balance sheet. It is recorded at cost plus the investor's share of post-acquisition income less any dividends paid.

EQUITY METHOD: EXAMPLE

Branch Inc. purchases a 20% interest in Williams Inc. for €200,000 on 1 January 2016. Williams reports income and dividends as follows:

Investor:	$A = L + E$	share of profit/loss from associate Equity Income	<u>Income</u>	<u>Dividends</u> of investee
	investment $A = L + E$			
2016	$+ 200K \times 20\%$ $= 40,000$	$+ 40,000$ non-cash	2016 €200,000	€50,000
			2017 300,000	100,000
			2018 <u>400,000</u>	<u>200,000</u>
			<u>€900,000</u>	<u>€350,000</u>
				550,000

From div:
 cash $50k \times 20\%$
 + 10,000 don't have to recognize dividend income
 investment only recognize share of profit from associate
 - 10,000 cash item
 div received from associate

Calculate the investment in Williams that appears on Branch's balance sheet as of the end of 2018:

retain within investee's equity

$$\text{Initial investment cost} \quad \text{earn} \quad \text{dividend}$$

$$€200,000 + 20\% \times (€900,000 - €350,000) = €310,000$$

if stock dividend
 $A = L + E$
 RIE ↓ CLST
 overall → equity doesn't change

FAIR VALUE VS EQUITY METHOD

- 1) On January 2, 2022, Maxi Co acquired 48,000 shares (20% of Mini Company ordinary shares) at a cost of \$10.
- 2) For the year 2022, Mini reported net income of \$200,000.
- 3) December 31, 2022, the Mini Company 48,000 shares have a fair value of \$12 per share. = $576,000$ share go up by \$2
- 4) On January 28, 2023, Mini Company announced and paid a cash dividend of \$100,000 or \$0.41667 per share)
- 5) For the year 2023, Mini reported a net loss of \$50,000. $-50,000 \times 20\% = -10,000$
- 6) December 31, 2023, the Mini Company 48,000 shares have a fair value of \$11 per share *bcs you want to have significant control
don't care fair value*

No.	Fair value			Equity method (20%)		
	Assets=	Liability+	Equity	Assets=	Liability+	Equity
1	Assets= <i>initial cost</i> Investment +480,000 Cash -480,000			Assets= Investment +480,000 Cash -480,000		
2	No transaction			Investment +40,000		Investment income +40,000
3	Investment +96,000		Unrealized gain/ loss (P/L) $576,000 - 480,000$ or $\$2 \times 48,000$		No transaction	
4	Cash +20,000		Dividend Income +20,000	Cash → $20\% \times 100,000$ Investment -20,000	<i>distribution of equity (dividend)</i>	
5	No transaction			Investment -10,000		Investment loss -10,000
6	Investment -48,000		Unrealized gain/ loss (P/L) -48,000 <i>-1 x 48,000 per share</i>		No transaction	

INVESTMENTS IN ASSOCIATES: WHEN INVESTMENT COSTS > BOOK VALUE OF INVESTEE

When investment costs exceed the investor's proportionate share of the investee's net identifiable assets, the difference is allocated to the following:

$$\text{Fair value } \$930,000 - \text{BV } \$100,000 = \$50,000$$

- Any specific assets whose fair values exceed book values. These amounts are then amortized over the useful life of these specific assets.
- Any remaining difference between the investment cost and the fair value of net identifiable assets that cannot be allocated to specific assets is treated as goodwill.
*will not see this as investor
cannot be identified
don't know useful life*
- Goodwill is not amortized; it is checked for impairment annually.
- Goodwill from investment in associates does not present separately. It is included in the carrying amount of investment (net of any accumulated impairment loss)
in PS, only show goodwill from business combination

INVESTMENTS IN ASSOCIATES: WHEN INVESTMENT COSTS > BOOK VALUE OF INVESTEE: EXAMPLE (1 OF 2)

Assume that Blake Co. acquires 30% of the outstanding shares of Brown Co. At the acquisition date, information on Brown's recorded assets and liabilities is as follows:

	Book Value	Fair Value	diff
Current assets	€10,000	€10,000	
Plant and equipment	190,000	220,000	+ 30,000
Land	120,000	140,000	+ 20,000
	€320,000	€370,000	
Liabilities	100,000	100,000	
Net assets	€220,000	€270,000	

pay only
30%
of
incremental
amount

Blake Co. believes the value of Brown Co. is higher than the fair value of its identifiable net assets. They offer €100,000 for a 30% interest in Brown Co. Calculate goodwill.

INVESTMENTS IN ASSOCIATES: WHEN INVESTMENT COSTS > BOOK VALUE OF INVESTEE: EXAMPLE (2 OF 2)

Purchase price	€100,000
30% of book value of Brown ($30\% \times €220,000$)	<u>66,000</u>
Excess purchase price	<u>34,000</u>
Attributable to net assets:	
Plant and equipment ($30\% \times €30,000$)	9,000
Land ($30\% \times €20,000$)	6,000
Goodwill	$34,000 - 9,000 - 6,000 = 19,000$
	€34,000

Account	Excess Price	Useful life	Amortization/year
Plant and equipment	9,000	10 years	900
Land	6,000	Indefinite	0
Goodwill	19,000	Indefinite	0

Example 3 Equity Method Investments with Goodwill

not control, just has some influence

↳ Inv in associate

On January 1, 2018, Parker Company acquired 30% of Prince Inc. common shares for the cash price of €500,000 (both companies are fictitious). It is determined that Parker has the ability to exert significant influence on Prince's financial and operating decisions. The following information concerning Prince's assets and liabilities on January 1, 2018 is provided:

investors can only see change of investment account
cannot see investee's BS

Prince, Inc.			
	Book Value	Fair Value	Difference
Current assets	€100,000	€100,000	€0
Plant and equipment	1,900,000	2,200,000	300,000
	€2,000,000	€2,300,000	€300,000
Liabilities	800,000	800,000	0
Net assets	€1,200,000	€1,500,000	€300,000

The plant and equipment are depreciated on a straight-line basis and have 10 years of remaining life. Prince reports net income for 2011 of €100,000 and pays dividends of €50,000. Calculate the following:

1. Goodwill included in the purchase price.
2. Investment in associate (Prince) at the end of 2018.

2)

Option 1: Investment (end of 2018)

investment on Jan 1, 2018 → get bigger (smaller based on performance of investee)
 consist of investee's (book value of PPE) $\times 30\%$
 size of investee's equity ↑ → investor's investment also get smaller per year

$$\begin{aligned}
 & \text{initial cost} \\
 & = \text{purchase price} \\
 & = \text{Cost} + 30\% \text{ Income} - 30\% \text{ Dividend} - \text{amortized expense} \\
 & = 500,000 + 30\%(100,000) - 30\%(50,000) - (90,000/10) \\
 & = 506,000
 \end{aligned}$$

excess fair value

Option 2: Investment (end of 2018)

$$\begin{aligned}
 \text{Prince's net asset (end of 2018)} &= 30\% \text{ (Prince's net asset (beginning 2018) + net income - dividend)} \\
 &= 30\% \text{ (1,200,000 + 100,000 - 50,000)} = 375,000
 \end{aligned}$$

$$\text{Unamortized excess price} = 140,000 - (90,000/10) = 131,000$$

$$\text{Investment (end of 2018)} = 375,000 + 131,000 = 506,000$$

FAIR VALUE OPTION AND IMPAIRMENT

not timely

Fair value option: The option at the time of initial recognition to record an equity method investment at fair value.

- Under IFRS, only venture capital firms, mutual funds, unit trusts, and similar entity may opt for fair value. *if there's active mkt to trade*
- Under U.S. GAAP, the fair value option is available to all entities.

Equity method investments need periodic reviews for impairment.

allow firm to mark-up, down fair value of asset

there is indicator that this asset will impair

do impairment test

it is true

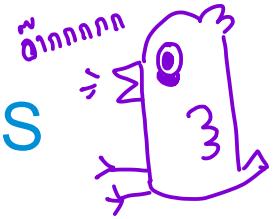
can reverse

record impairment loss

- Under IFRS, an impairment is recorded only if there is objective evidence that one (or more) loss event(s) has occurred since the initial recognition and that loss event has an impact on the investment's future cash flows, which must be reliably estimated.

- U.S. GAAP take a different approach. An impairment must be recognized if the fair value of the investment falls below its carrying value and if the decline is considered permanent.

cannot do impairment reversal
cannot revalue
↳ to prevent scandal



TRANSACTIONS WITH ASSOCIATES

An investor company can influence the terms and timing of transactions with its associates.

Thus, the investor company's share of any profits resulting from transactions with

associates must be deferred until the transactions are confirmed with a third party.

↑ associate sells e.g. inventory to its investor ⇒ boost its sales <not true value>

that investor firm has no control over

- In an **upstream sale**, the investee sells goods to the investor (associate to investor).
has influence over associate
not record until inventory is dissolve through 3rd party
 - The profit on the intercompany transaction is recorded on the associate's income (profit or loss) statement.
 - Investor's share of the unrealized profit is included in equity income on the investor's income statement.
- In a **downstream sale**, the investor sells goods to the investee (investor to associate).
 - The profit on the intercompany transaction is recorded on the investor's income (profit or loss) statement.
- Regardless of directions, IFRS and U.S. GAAP require the elimination of profits to the extent of the investor's ownership of the investee.

Example 4 Equity Method with Sale of Inventory: Upstream Sale

On January 1, 2018, Wicker Company acquired a 25% interest in Foxworth Company (both companies are fictitious) for €1,000,000 and used the equity method to account for its investment. The book value of Foxworth's net assets on that date was €3,800,000. An analysis of fair values revealed that all fair values of assets and liabilities were equal to book values except for a building. The building was undervalued by €40,000 and has a 20-year remaining life. The company used straight-line depreciation for the building. Foxworth paid €3,200 in dividends in 2018. During 2018, Foxworth reported net income of €20,000. During the year, Foxworth sold inventory to Wicker. At the end of the year, there was €8,000 profit from the upstream sale in Foxworth's net income. The inventory sold to Wicker by Foxworth had not been sold to an outside party.

investee sells its products to investor

1. Calculate the equity income to be reported as a line item on Wicker's 2018 income statement.
2. Calculate the balance in the investment in Foxworth to be reported on the December 31, 2018 balance sheet.

Purchase price	€1,000,000
Acquired equity in book value of Foxworth's net assets ($25\% \times €3,800,000$)	950,000
Excess purchase price	€50,000
Attributable to:	
Building ($25\% \times €40,000$)	€10,000
Goodwill (residual)	40,000
	€50,000



1) Equity Income

$$\begin{aligned}
 &= \text{Wicker's share of Foxworth's NI} - \text{amortized expense} \\
 &= 25\%(20,000 - 8,000) - (10,000/20) \\
 &= 2,500
 \end{aligned}$$

not related party
in Wicker's 3rd party item
cannot recognize this
in Wicker's investment account
in Wicker's upstream & downstream sale

2) option1: Investee performance

$$\begin{aligned}
 \text{Investment (2018)} &= \text{Cost} + [25\% * \text{Income} - \text{amortized expense}] - 25\% * \text{Dividend} \\
 &= 1,000,000 + 2,500 - 25\% * 3,200 \\
 &= 1,001,700
 \end{aligned}$$

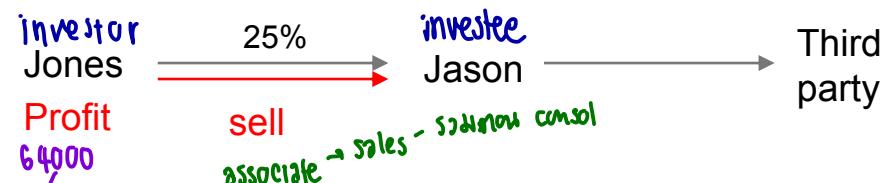
Option2: Investment (end of 2018)

$$\begin{aligned}
 &= 25\% * \text{Foxworth's net asset (end of 2018)} + \text{extra} \\
 &= 25\% * (\text{Foxworth's net asset (beginning 2018)} + \text{net income} - \text{dividend}) + \text{unamortized excess price} \\
 &= 25\% * (3,800,000 + 20,000 - 8,000 - 3,200) + \text{dividend} \\
 &= 25\% * (3,800,000 + 20,000 - 8,000 - 3,200) + \frac{\text{excess price}}{(50,000 - 500)} \rightarrow \text{depre of excess building} \\
 &= 1,001,700 \quad \text{remaining value after 1yr} \frac{10000}{20}
 \end{aligned}$$

Example 5 Equity Method with Sale of Inventory: Downstream Sale

Investor Jones Company owns 25% of Jason Company (both fictitious companies) and appropriately applies the equity method of accounting. Amortization of excess purchase price, related to undervalued assets at the time of the investment, is €8,000 per year. During 2017 Jones sold €96,000 of inventory to Jason for €160,000. Jason resold €120,000 of this inventory during 2017. The remainder was sold in 2018. Jason reports income from its operations of €800,000 in 2017 and €820,000 in 2018.

1. Calculate the equity income to be reported as a line item on Jones's 2017 income statement.
2. Calculate the equity income to be reported as a line item on Jones's 2018 income statement.



Jone sold €96,000 for €160,000

profit = € 64,000 cannot sell it all

Jason sells € 120,000 out of € 160,000 to a third party
↓ of what they have still in investee warehouse

Jason sell 75%; 25% is unsold.

Unrealized profit = $25\% * 64,000 = € 16,000$ *to Jones*

Jones's share of unrealized profit (2017)

$$= 25\% * 16,000 = € 4,000$$

↳ hidden profit in the unsold inventory (ending inventory)

Equity income (2017)

$$\begin{aligned} &= \text{Jones's share of Jason's NI} - \text{amortized expense} \\ &= 25\%(800,000) - 4,000 - 8,000 \\ &= 188,000 \end{aligned}$$

inventory still in investee

Equity income (2018)

$$\begin{aligned} &= \text{Jones's share of Jason's NI} - \text{amortized expense} \\ &= 25\%(820,000) + 4,000 - 8,000 \\ &= 201,000 \end{aligned}$$

JOINT VENTURE

- A joint venture can be a convenient way to enter foreign markets, conduct specialized activities, and engage in risky projects.
- Joint ventures are defined differently under IFRS and U.S. GAAP.

Under IFRS:

- Three types of joint ventures: jointly controlled operations, jointly controlled assets, and jointly controlled entities (a joint venture that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest).
- *The equity method* is the required accounting treatment for joint ventures.

Under U.S. GAAP:

- Joint venture refers only to jointly controlled separate entities.
- *The equity method* is the required accounting treatment for joint ventures.

ISSUE FOR ANALYSTS

- Question if accounting method is appropriate.
 - An investor holding 19% of associate may exert significant influence and attempt to avoid using equity method to report associate's net loss.
 - An investor holding 25% of associate may unable to exert significant influence. Thus, the investor may prefer the equity method to capture associate's income.
has influence on
- The investment account represents the investor's percentage ownership in the net assets of the investee company through “one-line consolidation.” *see only investment account*
- Significant assets and liabilities of the investee are not reflected on the investor's balance sheet, which will significantly affect financial ratios.

BUSINESS COMBINATIONS

- An investor has *control* over an investee. (ownership percentage > 50%)
 - It is said to have a *controlling interest*.
 - Investor is referred as the **parent** and the investee as the **subsidiary(minority interest)**.
- Business combinations involve the combination of two or more entities into a larger economic entity. They are motivated by expectations of added value through synergies.
- Types of business combinations:
 - Under **IFRS**, there is no distinction among business combinations based on the resulting structure of the larger economic entity.
 - Under U.S. GAAP, business combinations are categorized as merger, acquisition, or consolidation based on the structure after the combination.

TYPE OF BUSINESS COMBINATIONS

- **Merger:** only one entity remains in existence. 100% of target is absorbed into the acquiring company.

Company A + Company B = Company A

- **Acquisition:** the legal continuity of the entities. Each entity continues operations but is connected through a parent–subsidiary relationship.

- Each entity is an individual that maintains separate financial records, but the parent (the acquirer) provides consolidated financial statements in each reporting period.

Company A + Company B = (Company A + Company B)

- **Consolidation:** a new legal entity is formed and none of the predecessor entities remain in existence.

Company A + Company B = Company C

ACCOUNTING FOR BUSINESS COMBINATIONS (1 OF 2)

- IFRS and U.S. GAAP now require that all business combinations be accounted for using the **acquisition method**.
- Identifiable assets and liabilities of the acquired company are measured at fair value on the date of the acquisition.
- Assets and liabilities that were not previously recognized by the acquiree must be recognized by the acquirer.
 - Patents, brand names, technology
- At the acquisition date, the acquirer can reclassify the financial assets and liabilities of the acquiree (e.g., from trading security to available for sale security).

e.g. debt investment → change obj as target firm
but new owner's obj is to hold for trading
change to this

ACCOUNTING FOR BUSINESS COMBINATIONS (2 OF 2)

- When acquisition price is greater than fair value of acquiree's net assets,
Goodwill is recognized as:
- "Partial goodwill" under IFRS: the difference between purchase price and the acquirer's share of acquiree's fair value of identifiable assets and liabilities.
- "Full goodwill" under U.S. GAAP and IFRS: the difference between total fair value of the acquiree and fair value of the acquiree's identifiable net assets.
- When acquisition price is less than fair value of acquiree's net assets, this acquisition is called a "bargain purchase" acquisition.
- Gain = the fair value of identifiable net assets and the purchase price.
- Immediately recognized gain in profit or loss.

NON-CONTROLLING (MINORITY) INTERESTS: BALANCE SHEET

- A non-controlling interest is the portion of the subsidiary's equity (residual interest) that is held by third party (i.e. not owned by the parent).
- Noncontrolling interests are shown as a separate component of equity on the balance sheet and a separate line item in the income statement.
- IFRS and U.S. GAAP differ on the measurement of noncontrolling interest:
 - Under IFRS, the value of the noncontrolling interest is either its fair value (full goodwill method) or the noncontrolling interest's proportionate share of the acquiree's identifiable net assets (partial goodwill method).
 - Under U.S. GAAP, the parent must use the full goodwill method and measure the noncontrolling interest at fair value.

GOODWILL AND NON-CONTROLLING INTEREST

acquiring 100% of subsidiary
Full Goodwill (100%):, pay for something that cannot be identified too *willing to pay more*

$$\text{Goodwill} = \text{FV}(\text{Subsidiary}) - \text{FV}'(\text{subsidiary identifiable net asset})$$

$$\text{Non-controlling interest (NCI)} = \text{NCI percentage} * \text{FV}(\text{Subsidiary})$$

Partial Goodwill (acquisition%):

$$\text{Goodwill} = \text{acquisition\%} * (\text{FV}(\text{subsidiary}) - \text{FV}(\text{subsidiary identifiable net asset}))$$

$$= \underbrace{\text{acquisition \%} * \text{FV}(\text{subsidiary})}_{\text{purchase price}} - [\text{acquisition \%} * \text{FV}(\text{subsidiary identifiable net asset})]$$

$$= \text{acquisition price} - [\text{acquisition\%} * \text{FV}(\text{subsidiary identifiable net asset})]$$

$$\text{Non-controlling interest (NCI)} = \text{NCI percentage} * \text{FV}(\text{subsidiary identifiable net asset})$$

PARTIAL VS FULL GOODWILL

Example 6 Recognition and Measurement of Goodwill

Acquirer contributes \$800,000 for an 80% interest in Acquiree. The identifiable net assets have a fair value of \$900,000. The fair value of the entire entity is determined to be \$1 million.

	80% IFRS Partial Goodwill
Fair value of consideration <i>purchase price</i>	\$800,000
80% of Fair value of identifiable net assets	720,000
Goodwill recognized	\$80,000
	IFRS and US GAAP 100% Full Goodwill
Fair value of entity	\$1,000,000
Fair value of identifiable assets	<i>900,000</i>
Goodwill recognized	\$100,000

6 100% = 1 mm

900,000 x 80%

80% x 100,000

100% ACQUISITION: EXAMPLE (1 OF 2)

Franklin Co. acquired 100% of Jefferson, Inc. by issuing 1,000,000 shares of its €1 par common stock (€15 market value). Immediately before the transaction, the two companies had the following information:

	^{parent} Franklin Book Value (000)	^{subsidiary after acquisition} Jefferson Book Value (000)	^{fair} Jefferson Fair Value (000)
Cash and receivables	10000	300	300
Inventory	12,000	1,700	3,000
PP&E (net)	27,000	2,500	4,500
	49000	4500	7800
Current payables	8,000	600	600
Long-term debt	16,000	2,000	1,800
	24,000	2,600	2,400
Net assets	25000	1900	5400
Shareholders' equity:			
Capital stock (€1 par)	5000	400	0.84 million euros
Additional paid in capital	6,000	700	
Retained earnings	14000	800	

Show the postcombination balance sheet using the acquisition method.

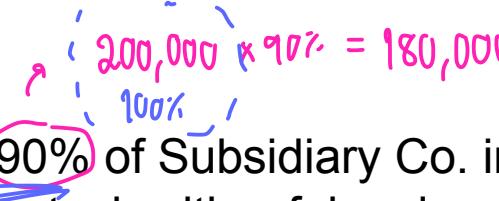
100% ACQUISITION: EXAMPLE (2 OF 2)

- Goodwill = Purchase price/FV(subsidiary) – FV(identifiable net assets)
 $= (\$15 * 1,000,000) - (5,400,000)$
 $= 9,600,000$
- FV identifiable net asset
15400 x 1000000*

	BV(Parent)	+ FV(subsidiary)	= Consolidated
Cash and receivables	€10,000	€300	€10,300
Inventory	12,000	3,000	15,000
PP&E (net)	27,000	4,500	31,500
Goodwill	0	0	<u>9,600</u>
Total assets	<u>€49,000</u>	<u>€7,800</u>	<u>€66,400</u>
Current payables	€8,000	€600	€8,600
Long-term debt	<u>16,000</u>	<u>1,800</u>	<u>17,800</u>
Total liabilities	€24,000	€2,400	€26,400
Capital stock (€1 par)	€5,000	€1,000	€6,000
Additional paid in capital	6,000	14,000	20,000
Retained earnings	<u>14,000</u>		<u>14,000</u>
Total stockholders' equity	<u>€25,000</u>		<u>€40,000</u>
Total liabilities and stockholders' equity	<u>€49,000</u>		<u>€66,400</u>

LESS THAN 100% ACQUISITION: EXAMPLE (1 OF 3)

On 1 January 2018, Parent Co. acquired **90%** of Subsidiary Co. in exchange for shares of Parent Co.'s no par common stock with a fair value of **€180,000**. The fair market value of the subsidiary's shares on the date of transaction was €200,000. Below is selected financial information from the two companies immediately before the parent recorded the acquisition:



	Parent Book	Subsidiary	
		Book Value	Fair Value
Cash and receivables	40,000	15,000	15,000
Inventory	125,000	80,000	80,000
PP&E (net)	235,000	95,000	155,000
	400,000	190,000	250,000
Payables	55,000	20,000	20,000
Long-term debt	120,000	70,000	70,000
	175,000	90,000	90,000
Net assets	225,000	100,000	160,000
Shareholders' equity:			
Capital stock (no par)	87,000	34,000	
Retained earnings	138,000	66,000	

LESS THAN 100% ACQUISITION: EXAMPLE (2 OF 3)

1. Calculate the value of PP&E (property, plant, and equipment) on the consolidated balance sheet under both IFRS and U.S. GAAP.

$$\text{consolidated amount}$$
$$\text{€}235,000 + \text{€}155,000 = \text{€}390,000$$

2. Calculate the value of goodwill and the value of the noncontrolling interest at the acquisition date under *the full goodwill method*.

<i>partial goodwill 10% x €40,000 = €6,000 ↑</i>	Fair value of subsidiary <i>100%</i>	€200,000
	Fair value of subsidiary's identifiable net assets	<u>160,000</u>
	Goodwill <i>full gw (100%)</i>	<u>€40,000</u>

*→ net asset
subsidiary*

The value of noncontrolling interest = $10\% \times \text{€}200,000 = \text{€}20,000$

FV(subsidiary's share)

LESS THAN 100% ACQUISITION: EXAMPLE (3 OF 3)

3. Calculate the value of goodwill and the value of the noncontrolling interest at the acquisition date under *the partial goodwill method*.

Purchase price (90% of fair value of subsidiary)	€180,000
<u>90% of fair value of subsidiary's identifiable net assets</u>	<u>144,000</u>
Goodwill <i>90%</i>	<u>€36,000</u>

Value of noncontrolling interest = $10\% \times €160,000 = €16,000$

FV(subsidiary's identifiable net assets)

CONSOLIDATED BALANCE SHEET: ACQUISITION DATE

	US GAAP	Inconsistent with accounting standard , not multiply other than own with gain but 100% ownership is same
	Full Goodwill	Partial Goodwill
Cash and receivables	€55,000	€55,000
Inventory	205,000	205,000
PP&E (net)	390,000	390,000
Goodwill	40,000	36,000
Total assets	€690,000	€686,000
Payables	€75,000	€75,000
Long-term debt	190,000	190,000
Total liabilities	€265,000	€265,000
Shareholders' equity:		
Noncontrolling interests	€20,000	€16,000
Capital stock (no par)	€267,000	€267,000
Retained earnings	138,000	138,000
Total equity	€425,000	€421,000
Total liabilities and shareholders' equity	€690,000	€686,000

GOODWILL- IFRS

- Because the full goodwill method and the partial goodwill method result in different total assets and stockholders' equity, the impact of these methods on financial ratios would differ.
- Goodwill is *not amortized*, but it is tested for impairment at least annually or more frequently if events or changes in circumstances indicate that it might be impaired.
 - Under IFRS, goodwill is impaired when the recoverable value of a business unit is below the carrying value (one-step approach).
 - Impairment test is conducted based on the cash-generating unit to which the goodwill is assigned.
 - Cash-generating unit = smallest identifiable group of assets that generate cash flow. *not be able to know sale price & cost like inventory*
 - Estimation of the recoverable amount for goodwill impairments is typically based on value-in-use estimates.
 - Goodwill impairment loss reversals are not permitted.
once it impair, it impair forever

GOODWILL-IFRS

current value

- EX1: The cash-generating unit of a French company has a carrying value of €1,400,000, which includes ^{embedded goodwill} €300,000 of allocated goodwill. The recoverable amount of the cash-generating unit is determined to be €1,300,000, and the estimated fair value of its identifiable net assets is €1,200,000. Calculate the impairment loss.

- Recoverable amount of unit = €1,300,000

- Carrying amount of unit = €1,400,000

- Impairment loss = € 100,000 (P/L)

- Goodwill allocated to cash-generated unit (B/S)

$$\text{beginning GW} \quad \text{goodwill is deducted by impairment loss} \\ = €300,000 - €100,000 = €200,000 \quad \text{ending GW}$$

- EX2: If the recoverable amount of the cash-generating unit had been €800,000 instead of €1,300,000.

- Impairment loss = €800,000 - €1,400,000 = - €600,000 (P/L)

- Goodwill allocated to cash-generated unit (B/S) = €300,000 - €300,000 = 0

- Remaining impairment loss = €600,000 - €300,000 = €300,000

- the remaining amount of the impairment loss (€300,000) would then be allocated on a pro rata basis to the other non-cash assets within the unit.

it's too high over-reported $A = L + E$

$$\begin{array}{rcl} €1.4M & = & \\ -0.6M & -0.1M & \\ \hline €0.8M & €1.3M & \end{array} \quad \begin{array}{l} \text{impairment loss} \\ -0.1M \quad -0.6M \end{array}$$



GOODWILL-U.S. GAAP

Was assigned GW

e.g. report value of factory

- Under U.S. GAAP, at the time of acquisition, the total amount of goodwill recognized is allocated to each of the acquirer's reporting unit (operating segment or component of an operating segment). instead of cash-generating unit
 - There are two steps:
 - 1) Identification of an impairment loss: , over reported
carrying value of a reporting unit (including GW) > its fair value
 - 2) Measurement of the impairment loss
- Impairment loss = carrying amount of GW - the implied fair value of the reporting unit's GW

in value assumption

GOODWILL-U.S. GAAP

- EX1: A reporting unit of a US corporation (e.g., a division) has a fair value of \$1,300,000 and a carrying value of \$1,400,000 that includes recorded goodwill of \$300,000. The estimated fair value of the identifiable net assets of the reporting unit at the impairment test date is \$1,200,000. Calculate the impairment loss.

- Step1: Identify potential impairment loss at the reporting unit level

Yes! Fair value of unit: \$1,300,000 < Carrying value \$1,400,000 → impairment loss!

- Step2: measure the impairment loss

• Implied GW = FV of reporting unit – Net assets of reporting unit
= \$1,300,000 - \$1,200,000
= \$100,000 → new value of GW

Impairment loss = carrying value of GW – implied GW
= \$300,000 – 100,000
= \$200,000

- Goodwill allocated to reporting unit = \$300,000 - \$200,000 = \$100,000
- EX2: If the fair value of the reporting unit was \$800,000 (instead of \$1,300,000).
the implied GW = - \$400,000. (GW = 0) *GW cannot be negative*
- In this case, the maximum amount of the impairment loss recognized would be \$300,000, the carrying amount of goodwill.

on 0.1 M 7uiju impairment loss * 7uiju! 070 allocate min asset to unit 14

SUMMARY OF ACCOUNTING TREATMENT FOR INTERCORPORATE INVESTMENTS

Type	Financial Assets	Associates ↓ has some significant control	Combinations	Joint Ventures
Influence	None/Little	Significant	Controlling	Shared
Typical ownership %	< 20%	20%–50%	> 50%	Varies
Accounting treatment	<p>only care about mkt value</p> <p>Amortized cost</p> <p>Fair value through profit or loss</p> <p>Fair value through other comprehensive income</p>	<u>investment</u> <u>Equity method</u>	Consolidation	Equity method (U.S. GAAP & IFRS)

SUMMARY (1 OF 2)

- Investments in other companies can take five basic forms:
 1. Investments in financial assets
 2. Investments in associates
 3. Joint ventures
 4. Business combinations
- Investments in financial assets are those in which the investor has no significant influence. They can be measured and reported as:
 - Fair value through profit or loss
 - Fair value through other comprehensive income
 - Amortized cost
- The equity method requires the investor to recognize income as earned rather than when dividends are received. This method is required by IFRS and US GAAP for investments in associates and joint ventures.

SUMMARY (2 OF 2)

- The equity investment is carried at cost, plus its share of post-acquisition income (after adjustments) less dividends received.
- The equity investment is reported as a single line item on the balance sheet and on the income statement.
- IFRS and US GAAP require the use of the acquisition method to account for business combinations.
- Goodwill is the difference between the acquisition value and the fair value of the target's identifiable net tangible and intangible assets.
- If the acquiring company acquires less than 100%, noncontrolling (minority) shareholders' interests are reported on the consolidated financial statements.
- Consolidated financial statements are prepared in each reporting period.

APPENDIX

VARIABLE INTEREST AND SPECIAL PURPOSE ENTITIES (1 OF 2)

- A VIE (variable interest entity) or SPE (special purpose entity) is an enterprise that is created to accommodate specific needs of the sponsoring entity. It may be used to securitize receivables, lease assets, and so on.
- In the past, sponsors were able to avoid consolidating SPEs on their financial statements because they did not have “control” (i.e., own a majority of the voting interest) of the SPE.
- By avoiding consolidation, sponsors did not have to report the assets and the liabilities of the SPE; financial performance as measured by unconsolidated financial statements was potentially misleading. The benefit to the sponsoring company was improved asset turnover, lower operating and financial leverage, and higher profitability.

VARIABLE INTEREST AND SPECIAL PURPOSE ENTITIES (2 OF 2)

- Under IFRS, a SPE must be consolidated if the substance of the relationship indicates control.
- Under U.S. GAAP, the primary beneficiary of a VIE (which is often the sponsor) must consolidate it as its subsidiary regardless of how much of an equity investment it has in the VIE.
 - VIE, a more general term than SPE, refers to an entity that is financially controlled by one or more parties that do not hold a majority voting interest.

SPE: EXAMPLE (1 OF 2)

Odena wants to raise €55 million in capital by borrowing against its financial receivables. To accomplish this objective, Odena can choose between the following:

- Alternative 1: Borrow directly against the receivables
- Alternative 2: Create a SPE, invest €5 million in the SPE, have the SPE borrow €55 million, and then use the funds to purchase €60 million of receivables from Odena.

Using the financial information provided, describe the effect of each alternative on Odena, assuming Odena will not have to consolidate the SPE.

SPE: EXAMPLE (2 OF 2)

Odena Balance Sheet		Alternative 1	Alternative 2
Cash	30000000	85000000	85000000
Accounts receivable	60,000,000	60,000,000	0
Investment in SPE			5,000,000
Other assets	40,000,000	40,000,000	40,000,000
Total assets	130000000	185000000	130000000
Current liabilities	27000000	27000000	27000000
Non-current liabilities	20,000,000	75,000,000	20,000,000
Total liabilities	47000000	102000000	47000000
Shareholder equity	83000000	83000000	83000000
Total liabilities and equity	130000000	185000000	130000000
Current ratio	3.33	5.37	3.15
Long-term debt to equity	0.24	0.9	0.24
Equity to total assets	0.64	0.44	0.64

10 / 10

1. Which of the following are reported at fair value?

(1 Point) □

- Debt investments. **amortized cost or fair value**
- Equity investments. **only fair value**
- Both debt and equity investments.
- None of these answer choices are correct.

2. Match the investment accounting approach with the correct valuation approach:

Not held-for-collection

Held-for-collection (1 Point) □

- Amortized cost; Amortized cost.
- Fair value; Fair value.
- Fair value; Amortized cost.
- Amortized cost; Fair value.

3. An unrealized holding gain or loss on a trading debt investment is the difference between the investment's (1 Point) □

- fair value and original cost.
- face value and amortized cost.
- fair value and amortized cost.
- face value and original cost.

fair value - carrying amount

4. Equity investments acquired by a corporation which are accounted for by recognizing unrealized holding gains or losses as other comprehensive income and as a separate component of equity are (1 Point) □

- non-trading where a company has holdings of less than 20%.
- trading investments where a company has holdings of less than 20%.
- investments where a company has holdings of between 20% and 50%. X
- investments where a company has holdings of more than 50%. X

equity method

5. When a company holds between 20% and 50% of the outstanding ordinary shares of an investee, which of the following statements applies? (1 Point)

- The investor should always use the equity method to account for its investment.
- The investor should use the equity method to account for its investment unless circumstances indicate that it is unable to exercise "significant influence" over the investee.
- The investor must use the fair value method unless it can clearly demonstrate the ability to exercise "significant influence" over the investee.
- The investor should always use the fair value method to account for its investment.

6. If the investor owns 60% of the investee's outstanding ordinary shares, the investor should generally account for this investment under the (1 Point)

- cost method.
- fair value method.
- consolidation equity method.
- consolidation method.

7. Santo Corporation declares and distributes a cash dividend that is a result of current earnings. How will the receipt of those dividends affect the investment account of the investor under each of the following accounting methods?

Fair Value Method Equity Method

(1 Point) **PIL**

dividend income

investment account
decreased by
amount of div

- no effect; decrease.

- increase; decrease.

- no effect; no effect.

- decrease; no effect.

8. Under the equity method of accounting for investments, an investor recognizes its share of the earnings in the period in which the (1 Point)

- investor sells the investment.
- investee declares a dividend.
- investee pays a dividend.
- earnings are reported by the investee in its financial statements.

✓ 9. On January 3, 2022, Moss Co. acquires £100,000 of Adam Company's 10-year, 10% bonds at a price of £106,418 to yield 9%. Interest is payable each December 31. The bonds are classified as held-for-collection. Assuming that Moss Co. uses the effective-interest method, what is the amount of interest revenue that would be recognized in 2022 related to these bonds? (1 Point)



£10,000

£10,642

£9,578

£9,540

$$106,418 \times 9\% = 9,577.62$$

$$P_0 = 66$$

✓ 10. Polska Inc. purchased 400 ordinary shares of Millay Manufacturing as a trading investment for £26,400. During the year, Millay Manufacturing paid a cash dividend of £6.50 per share. At year-end, Milay Manufacturing shares were selling for £69 per share. On the income statement for the year ended December 31, what is **the total amount of unrealized gain/loss and dividend revenue** reported by Polska, Inc.? (1 Point)

£2,600

£1,200

£1,400

£3,800

$$\begin{aligned} & \text{div} \\ & (6.5 \times 400) + ((69 - 66) \times 400) \\ & = 2,600 + 1,200 \\ & = 3,800 \end{aligned}$$

1

8/8

Cinnamon, Inc. is a diversified manufacturing company headquartered in the United Kingdom. It complies with IFRS. In 2017, Cinnamon held a 19 percent passive equity ownership interest in Cambridge Processing. In December 2017, Cinnamon announced that it would be increasing its ownership interest to 50 percent effective January 1, 2018 through a cash purchase. Cinnamon and Cambridge have no intercompany transactions. Peter Lubbock, an analyst following both Cinnamon and Cambridge, is curious how the increased stake will affect Cinnamon's consolidated financial statements. He asks Cinnamon's CFO how the company will account for the investment, and is told that the decision has not

and is told that the decision has not yet been made. Lubbock decides to use his existing forecasts for both companies' financial statements to compare the outcomes of alternative accounting treatments. Lubbock assembles abbreviated financial statement data for Cinnamon (Exhibit 1) and Cambridge (Exhibit 2) for this purpose.

In 2018, if Cinnamon is deemed to have control over Cambridge, it will most likely account for its investment in Cambridge using:

& 50% *business combination*

- the equity method.
- the acquisition (consolidation) method. ✓
- the fair value method.
- proportionate consolidation.

EXHIBIT 1 Selected Financial Statement Information for Cinnamon, Inc. (£ Millions)

Year ending December 31	2017	2018*
Revenue	1,400	1,575
Operating income	126	142
Net income	62	69
December 31	2017	2018*
Total assets	1,170	1,317
Shareholders' equity	616	685

*Estimates made prior to announcement of increased stake in Cambridge.

EXHIBIT 2 Selected Financial Statement Information for Cambridge Processing (£ Millions)

Year ending December 31	2017	2018*
Revenue	1,000	1,100
Operating income	80	88
Net income	40	44
Dividends paid	20	22
December 31	2017	2018*
Total assets	800	836
Shareholders' equity	440	462

*Estimates made prior to announcement of increased stake by Cinnamon.

✓ Correct 1/1 Points

2

Cinnamon, Inc. is a diversified manufacturing company headquartered in the United Kingdom.

It complies with IFRS. In 2017, Cinnamon held a 19 percent passive equity ownership interest in Cambridge Processing. In December 2017, Cinnamon announced that it would be increasing its ownership interest to 50 percent effective January 1, 2018 through a cash purchase.

Cinnamon and Cambridge have no intercompany transactions.

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CFO how the company will account for the investment, and is told that the decision has not

yet been made. Lubbock decides to use his existing forecasts for both companies' financial statements to compare the outcomes of alternative accounting treatments.

Lubbock assembles abbreviated financial statement data for Cinnamon (Exhibit 1) and Cambridge (Exhibit 2) for this purpose.

parent

At December 31, 2018, Cinnamon's total shareholders' equity on its balance sheet would most likely be:



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December 31	2017	2018*
Total assets	800	836
Shareholders' equity	440	462

*Estimates made prior to announcement of increased stake by Cinnamon.

- highest if Cinnamon is deemed to have control of Cambridge. ✓

- independent of the accounting method used for the investment in Cambridge. X

- highest if Cinnamon is deemed to have significant influence over Cambridge.

equity method → as investment in associate

↓
Share from associate (PIL)

↓
equity ↑

X Incorrect 0/1 Points

3

Cinnamon, Inc. is a diversified manufacturing company headquartered in the United Kingdom. It complies with IFRS. In 2017, Cinnamon held a 19 percent passive equity ownership interest in Cambridge Processing. In December 2017, Cinnamon announced that it would be increasing its ownership interest to 50 percent effective January 1, 2018 through a cash purchase. Cinnamon and Cambridge have no intercompany transactions. Peter Lubbock, an analyst following both Cinnamon and Cambridge, is curious how the increased stake will affect Cinnamon's consolidated financial statements. He asks Cinnamon's CFO how the company will account for the investment, and is told that the decision has not yet been made. Lubbock decides to use his existing forecasts for both companies' financial

forecasts for both companies' financial statements to compare the outcomes of alternative accounting treatments.

Lubbock assembles abbreviated financial statement data for Cinnamon (Exhibit 1) and Cambridge (Exhibit 2) for this purpose.

In 2018, Cinnamon's net profit margin would be highest if:



- it is deemed to have control of Cambridge X
- it had not increased its stake in Cambridge.
- it is deemed to have significant influence over Cambridge. ✓

EXHIBIT 1 Selected Financial Statement Information for Cinnamon, Inc. (£ Millions)

Year ending December 31	2017	2018*
Revenue	1,400	1,575
Operating income	126	142
Net income	62	69
December 31	2017	2018*
Total assets	1,170	1,317
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Year ending December 31	2017	2018*
Revenue	1,000	1,100
Operating income	80	88
Net income	40	44
Dividends paid	20	22
December 31	2017	2018*
Total assets	800	836
Shareholders' equity	440	462

*Estimates made prior to announcement of increased stake by Cinnamon.

$$\text{Net profit Margin} = \frac{\text{net profit}}{\text{Revenue}}$$

* assume no intercompany transactions

(1) Consol:

$$\% \text{ NP margin in 2018} = \frac{69 + 44}{1575 + 1100}$$

$$= \frac{113}{2675} = 4.2\%$$

② Inv in associate

assume 50%

$$\% \text{ NP margin} = \frac{64 + (44 \times 50\%)}{1575}$$

$$= 5.46\%$$

✓ Correct 1/1 Points

4

Cinnamon, Inc. is a diversified manufacturing company headquartered in the United Kingdom.

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interest in Cambridge Processing. In December 2017, Cinnamon announced that it would be increasing its ownership interest to 50 percent effective January 1, 2018 through a cash purchase.

Cinnamon and Cambridge have no intercompany transactions.

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and is told that the decision has not

yet been made. Lubbock decides to use his existing forecasts for both companies' financial

yet been made. Lubbock decides to use his existing forecasts for both companies' financial

statements to compare the outcomes of alternative accounting treatments.

Lubbock assembles abbreviated financial statement data for Cinnamon (Exhibit 1) and

Cambridge (Exhibit 2) for this purpose.

Compared to Cinnamon's operating margin in 2017, if it is deemed to have control of

Cambridge, its operating margin in 2018 will most likely be:

lower. ✓

higher.

the same.

EXHIBIT 1 Selected Financial Statement Information for Cinnamon, Inc. (£ Millions)

Year ending December 31	2017	2018*
Revenue	1,400	1,575
Operating income	126	142
Net income	62	69
December 31	2017	2018*
Total assets	1,170	1,317
Shareholders' equity	616	685

*Estimates made prior to announcement of increased stake in Cambridge.

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Revenue	1,000	1,100
Operating income	80	88
Net income	40	44
Dividends paid	20	22
December 31	2017	2018*
Total assets	800	836
Shareholders' equity	440	462

*Estimates made prior to announcement of increased stake by Cinnamon.

EBIT
revenue

5

On January 2, 2022 Pod Company purchased 25% of the outstanding ordinary shares of Jobs, Inc. and subsequently used the equity method to account for the investment. During 2022 Jobs, Inc. reported net income of €420,000 and distributed dividends of €180,000. The ending balance in the Equity Investments account at December 31, 2022 was €320,000 after applying the equity method during 2022. What was the purchase price Pod Company paid for its investment in Jobs, Inc? □₍₄₎

$$320,000 = \text{purchase price} + [(420,000 - 180,000) \times 25\%]$$

€170,000

€260,000 ✓

$$\text{purchase price} = 260,000$$

Feedback:

In 2022, investment increased by $25\% * (420,000 - 180,000) = €60,000$. The purchase price on January 2, 2022 was $320,000 - 60,000 = €260,000$.

€380,000

€470,000

✓ Correct 1/1 Points

6

Which of the following statement is incorrect about goodwill? □₍₄₎

, IS NOT PERMITTED!

Under IFRS, goodwill impairment loss reversal is allowed. ✓

Goodwill is not amortized. ✓ → Impaired

Under U.S. GAAP, the impairment loss incurs when carrying value of a reporting unit (including goodwill) is higher than its fair value. ✓

Under IFRS, goodwill is impaired when the recoverable value is lower than the carrying value. ✓

7

The cash-generating unit of a German company has a carrying value of €1,500,000, which includes €300,000 of allocated goodwill. The recoverable amount of the cash-generating unit is determined to be €1,200,000, and the estimated fair value of its identifiable net assets is €1,100,000.

Under IFRS, what amount does the company recognize as the impairment loss of goodwill?



- 100,000
- 300,000 ✓
- 400,000
- no impairment loss.

Impair!

$$\text{Carrying value of unit} = €1,500,000$$

$$\text{Recoverable amount of unit} = €1,200,000$$

$$\text{Impairment loss} = €300,000$$

$$* \text{Ending GW} = 300,000 - 300,000 = 0$$

✓ Correct 1/1 Points

8

The reporting unit of a German company has a carrying value of €1,500,000 which includes €300,000 of allocated goodwill. The fair value of the reporting unit is €1,200,000. The estimated fair value of its identifiable net assets is €1,100,000.

Under US GAAP, what amount does the company recognize as the impairment loss of goodwill?

- 100,000
- 200,000 ✓
- 300,000
- 400,000

① Carrying value ^{unit} = € 1,500,000
 Fair value of unit = € 1,200,000 → lower ⇒ Impair!

② Implied GW: FV of unit - Net assets of reporting unit
 $= 1,200,000 - 1,100,000$
 $= 100,000$

$$* \text{Impairment loss} = \text{carrying value of GW} - \text{implied GW}$$

$$= 300,000 - 100,000$$

$$= 200,000$$

