

CHAPTER 16

Investments and International Operations

Chapter Overview

This chapter begins with a discussion of share investments, various reasons why investors buy shares, and how share investments are classified according to ASPE. Students first learn how to account for short-term share investments without significant influence using the fair-value method of accounting for investments. Entries are included for the purchase and sale of the investment and for receipt of dividends; balance sheet presentation is included. Accounting for short-term bond investments is briefly described. Accounting for long-term share investments is then presented. The fair-value method is used for long-term share investments without significant influence. The equity method, used when the investor holds 20-50% of the investee's voting shares (significant influence), is explained and various transactions are illustrated. The consolidation method, used when the investor (parent) holds more than 50% of the investee (subsidiary) corporation's voting shares, is covered, along with how to prepare a consolidated balance sheet when the parent corporation owns all of the subsidiary's shares and when there is non-controlling interest because the parent owns less than 100%.

The next section covers long-term investments in bonds and notes, which are accounted for using the amortized cost method. Various entries, including amortization of bond discount and premium, are presented.

The chapter then focuses on accounting for international operations. The discussion includes foreign-currency exchange rates, international transactions, and hedging. Journal entries help explain purchases and sales on account and foreign-currency transaction gains and losses. The chapter concludes with a discussion on the impact of IFRS.

Try It! questions appear at the end of each Learning Objective for students to test their understanding of the Learning Objective just completed. The answers appear at the end of the chapter and on MyLab Accounting.

Students should be directed to MyLab for extra practice. Also included on MyLab are Excel templates for Exercise 16-9 and Problems 16-4A, 16-5A, 16-4B, and 16-5B.

The **Assignment Grid** recommends "Pre-Test" problems in MyLab that can be assigned before a test or exam to ensure students understand the topics, as well as "Post-Test" problems that students can complete after a test or exam to check understanding before moving on.

Connecting Learning Objectives and Key Questions

	Learning Objective	Key Question
1	Account for short-term investments	How do we account for short-term investments?
2	Account for long-term share investments	How we account for long-term share investments?
3	Use the equity method to account for investments	What is the equity method, and how do we use it?
4	Describe and create consolidated financial statements	What is consolidation, and how do we perform a simple consolidation?
5	Account for investments in bonds	How do we record investments in bonds?
6	Account for foreign-currency transactions	How do we record transactions in foreign currencies?
7	Identify the impact of IFRS on accounting for investments and international transactions	How does IFRS apply to investments and international transactions?

Suggested Priority of Chapter Topics

Must cover

- Share investments
- Accounting for short-term investments
- Accounting for long-term share investments
- Long-term share investments without significant influence
- Long-term share investments with significant influence
- Consolidated financial statements
- Investments in bonds
- Foreign currency transactions

Recommended

- The impact of IFRS on accounting for investments and international transactions

Chapter Outline

Share investments are shares of a corporation (the **investee**) that have been purchased by an **investor**. Share price information of public companies are quoted as illustrated in Exhibit 16-1

- A. **Short-term investments** must be liquid (readily convertible to cash). Generally, the investor *intends* to convert the investments to cash within one year but may continue to hold the investments for a longer period.
- B. Other equity investments that are *not* short-term investments are categorized as **long-term** investments. They are categorized as current or long-term based on the length of time management intends to hold the investment. Refer to Exhibit 16-2 for balance sheet presentation of both short-term and long-term investments.

Teaching Tip

Point out that the classification of long-term investments is based on the length of time management intends to hold the investment, ownership interest, and ability to influence.

Learning Objective 1: Account for short-term investments.

(How do we account for short-term investments?)

- A. The **fair-value method**, or **market-value method**, is used to account for short-term investments in shares.
 - 1. When these investments are purchased, they are recorded at **cost** (with a debit to Short-term Investments), which is the price paid for the shares. Brokerage commission and other transaction costs are expensed.
 - 2. Cash dividends are reported as dividend revenue. If dividends are declared but not received until after the year end, the investor *may* debit Dividend Receivable and credit Dividend Revenue on the declaration date.
 - 3. Stock dividends are reported with a memo general journal entry only. The cost of the investment remains the same, but the number of shares has increased.
 - 4. When a short-term investment is sold, the gain or loss is the difference between the sales proceeds and the last carrying amount on the balance sheet.
 - 5. Short-term Investments are reported on the balance sheet at their fair value.

If **market value > cost**, the entry to record the adjustment is:

Fair-Value Valuation Allowance	XX	
Unrealized Gain on Fair-Value Adjustment		XX

If **market value < cost**, the entry to record the write-down is:

Unrealized Loss on Fair-Value Adjustment	XX
Fair-Value Valuation Allowance	XX

Unrealized Loss/Gain on Fair-Value Adjustment is reported as other gains and losses to arrive at net income.

Teaching Tip

Point out that no matter how much the market value of the short-term investment has changed, it (the short-term investment) will always be reflected on the year-end financial statements at its fair value.

B. The fair-value method is used to account for short-term investments in bonds.

1. Accounting is similar to the accounting for short-term investments in shares.
2. Premiums or discounts are not amortized as the intent is to hold the bonds for a short period of time.

Learning Objective 2: Account for long-term share investments.

(How we account for long-term share investments?)

There are three types of long-term equity investments, depending on the purpose of the investment and the percentage of the voting interest acquired. Refer to Exhibit 16-3.

A. **Long-term equity investments without significant influence-** the fair-value method of accounting for the investment..

1. The investor holds the investment to earn dividend revenue and generally holds **< 20 percent** of the voting interest of the investee and would normally play no important role in the investee's operations.
2. These investments are recorded at cost when purchased; transactions costs are expensed; dividends are treated as income; gains and losses are recorded on sales. They are reported at fair-value on the balance sheet.

Learning Objective 3: Use the equity method to account for investments.

(What is the equity method, and how do we use it?)

- A. Long-term investments of **between 20% and 50%** of the investee's outstanding shares usually require the use of the **equity method**. (However, in certain circumstances, an investor with less than a 20 percent holding may still exert significant influence if there are many other shareholders who all own a few shares. In another case, a shareholder with a large holding, such as a 30 percent holding, may exert no significant influence if another shareholder owns 51% of the shares and thus has control of the corporation.)

1. The investor may have *significant influence* on how the investee operates its business.
2. The investment is initially recorded at **cost**, with a debit to Investment in X Corporation Common Shares.
3. The *investor's percentage of the investee's net income* is recorded with the following entry:

Investment in X Corporation Common Shares	XX	
Equity-Method Investment Revenue		XX

4. **Dividends** received by the investor are recorded with this entry:

Cash	XX	
Investment in X Corporation Common Shares		XX

5. **Gain or loss on the sale** of the investment is the difference between the sales proceeds and the carrying amount of the investment.

Teaching Tip

Review the accounts that are increased or decreased because of the initial investment, recognition of the proportional share of investee income, the receipt of dividends, and the subsequent sale of the investment.

- B. **Long-term investments of greater than 50%** of the outstanding shares of the investee (subsidiary) require **consolidation accounting**.
 1. The investor or **parent** has controlling (majority) interest of the investee or **subsidiary**. (Refer to Exhibits 16-4 and 16-5)
 2. **Consolidation accounting** combines financial statements of two or more companies that are controlled by the same owners into one set of consolidated statements. (Exhibit 16-5 presents accounting methods used depending on the investor's percentage of ownership in the investee company.)

Learning Objective 4: Describe and create consolidated financial statements.
(What is consolidation, and how do we perform a simple consolidation?)

- A. **Consolidated financial statements** help provide better insight into the total operations of the parent and its subsidiaries. Assets, liabilities, shareholders' equity, revenues, and expenses of the subsidiary are added to the parent's accounts. Exhibit 16-6 shows a parent company with a subsidiary.
- B. Both parent and subsidiaries keep their own separate set of books.
- C. **Goodwill** is an intangible asset that arises when the purchase price of the subsidiary is greater than the market value of its net assets, calculated as assets minus liabilities.

- D. **Non-controlling interest** (sometimes called *minority interest*) represents the portion of the subsidiary's shares owned by outsiders; it is usually reported as a liability between the liabilities and shareholders' equity on the consolidated balance sheet.
- E. The **consolidated balance sheet** will show the assets and liabilities of both the parent and the subsidiary. It is important that the same item *not* be counted twice in a set of consolidated financial statements. (See Exhibit 16-8.)
- F. A work sheet is useful when preparing consolidated statements. Elimination entries are necessary to correctly report the financial statements of the consolidated entity. These entries are prepared on the consolidation work sheet but are *not recorded on the books* of either the parent or the subsidiary.
 - 1. When the **parent owns 100% of the subsidiary's shares without paying for goodwill**, the elimination entries will remove *all* the subsidiary's shareholders' equity from the consolidated statements. (See the work sheet in Exhibit 16-6.)
 - a. First, *eliminate the parent's Investment account* (because a consolidated entity cannot report an investment in itself as an asset) and *eliminate the shareholders' equity of the subsidiary*.
 - b. Then *eliminate intercompany receivables and payables* because these are not receivables and payables to outside entities.
 - 2. When the **parent owns 100% of the subsidiary's shares and pays for goodwill**, the elimination entries necessary are illustrated on the work sheet in Exhibit 16-7.
 - a. Elimination entries eliminate the parent's Investment account and the shareholders' equity of the subsidiary.
 - b. Eliminate intercompany receivables and payables, as previously described.
 - c. Record any goodwill.
 - 3. When the **parent owns less than 100% of the subsidiary's shares**, a new category of shareholders' equity—non-controlling interest—will appear on the consolidated balance sheet. The non-controlling interest portion of the subsidiary's shareholders' equity is credited to the new liability account, **non-controlling interest**. The elimination entries necessary are illustrated on the work sheet in Exhibit 16-8.
 - a. Eliminate the shareholders' equity accounts of the subsidiary.
 - b. Eliminate the Investment in Subsidiary account.
 - c. Eliminate intercompany receivables and payables.
 - d. Record any goodwill (if applicable. In the example in Exhibit 16-9, this step is not applicable).
 - e. Record any non-controlling interest.
- G. The **consolidated income statement** will show the net income of the parent plus the parent's proportionate share of each subsidiary's net income.
- H. Computer spreadsheet programs and integrated accounting information systems ease the

preparation of the consolidated financial statements.

Teaching Tip

Point out that a company is considered a parent only when ownership is greater than 50 percent and the parent can exercise control over the subsidiary. In these situations, consolidation accounting is required. Review the highlights presented in the text and discuss the role that goodwill plays on the parent's balance sheet.

Learning Objective 5: Account for investments in bonds

(How do we record investments in bonds?)

- A. For the investor, the cost of bonds includes the purchase price plus any brokerage fees or other transaction costs. Short-term investments in bonds are rare.
- B. Investments in bonds or notes are usually long-term (non-current) assets. This type of bond investment is accounted for by the **amortized cost method**.
 - 1. Record the investment at **cost** (purchases price plus fees) and report the carrying amount of the investment on the balance sheet at **amortized cost**; that is, its cost less unamortized discount or cost plus unamortized premium.
 - 2. The discount or premium is amortized directly to the Investment account; amortizing the discount increases the Investment account, while amortizing the premium reduces the Investment account.
 - 3. Interest revenue is recorded when interest payments are received or are accrued at year end.
 - 4. A footnote to the financial statements includes the current market value of the investment as of the balance sheet date.
 - 5. If the market value of a long-term bond investment declines below cost and the decline is considered to be other than temporary, the investment should be *written down to market*.

Teaching Tip

Review the journal entries in learning objective 5. Point out the effect of amortizing bond discount and premium on the carrying value of the bond.

Learning Objective 6: Account for foreign-currency transactions

(How do we record transactions in foreign currencies?)

- A. Many Canadian companies do much of their business in foreign countries.
- B. Each country uses its own currency. A **foreign-currency exchange rate** is used to state one country's currency in terms of another country's currency. Several examples of foreign-currency

exchange rates are given in Exhibit 16-12.

When the demand for a nation's currency exceeds the supply of that currency, its exchange rate rises. When supply exceeds demand, the currency's exchange rate falls.

Translation is the process of converting the cost of an item given in one currency to its cost in a second currency.

A **strong currency** results when the country's exchange rate is rising relative to other nations' currencies.

A **weak currency** results when the country's exchange rate is falling relative to other nations' currencies.

C. **International transactions** can be recorded in the foreign currency or in Canadian currency.

1. When purchasing or selling goods on account, a **foreign-currency transaction gain or loss** may occur.
2. The foreign-currency exchange rate may be different on the day the purchase or sale is recorded than on the day when the payment or receipt actually occurs.
 - a. A **foreign-currency transaction loss (an "other" expense)** occurs when less cash is received due to a decline in the foreign country's exchange rate or when more cash must be paid due to an increase in the foreign country's exchange rate.
 - b. A **foreign-currency transaction gain (an "other" revenue)** occurs when more cash is received due to an increase in the foreign country's exchange rate or when less cash must be paid due to a decrease in the foreign country's exchange rate.
 - c. Foreign-currency transaction gains and losses are combined for each accounting period. The net amount of gain or loss can be reported as Other Revenue and Expense on the income statement.
3. The following entries relate to receipts and payments in a foreign currency:

Cash receipts in a foreign currency

Sale on account:

Accounts Receivable	XX	
Sales Revenue		XX

Collection on account:

Cash	XX	
Foreign-Currency Transaction Loss	XX	
Accounts Receivable		XX

Note: A transaction gain is recorded as a credit

Cash payments in a foreign currency

Purchase on account:

Inventory	XX	
Accounts Payable		XX

Payment on account:

Accounts Payable	XX	
Foreign-Currency Transaction Gain		XX
Cash		XX

Note: A transaction loss is recorded as a debit

D. **Hedging** is a means of protecting oneself from losing in foreign currency transactions by engaging in another transaction that will offset any foreign-currency transaction gain or loss.

Learning Objective 7: Identify the impact of IFRS on accounting for investments and international transactions

(How does IFRS apply to investments and international transactions?)

Some differences between ASPE and IFRS remain. See Exhibit 16-14.

Assignment Grid (2nd column: * = Excel Template available; W = writing required)

Assignment		Topic(s)	Learning Objective(s)	Time in Minutes	Level of Difficulty	MyLab Pre-Test/ Post-Test
Starter 16-1		Computing the cost of an investment in shares	1,2	5-10	Easy	
Starter 16-2		Accounting for a short-term investment	1	10-15	Easy	
Starter 16-3		Accounting for a short-term investment	1	10-15	Easy	
Starter 16-4		Classifying investments as short term or long term	1,2	5	Easy	
Starter 16-5		Year-end adjustments to market value	2	5-10	Easy	
Starter 16-6		Measuring gain or loss on the sale of a long-term share investment after receiving a stock dividend	1	5-10	Easy	
Starter 16-7		Accounting for a long-term investment's unrealized gain or loss	2	15-20	Easy	
Starter 16-8		Accounting for the sale of a long-term investment	2	5-10	Medium	
Starter 16-9		Accounting for a 40% investment in another company	3	10-15	Medium	
Starter 16-10		Accounting for an investment with significant influence	3	10-15	Medium	
Starter 16-11	W	Understanding consolidated financial statements	4	10	Medium	
Starter 16-12		Reading consolidated financial statements	4	5	Easy	
Starter 16-13		Working with a bond investment	5	10-15	Medium	
Starter 16-14		Recording bond investment transactions	5	10-15	Medium	
Starter 16-15		Recording and reporting bond investments	5	10-15	Medium	
Starter 16-16		Accounting for purchase transactions stated in a foreign currency	6	10	Medium	
Starter 16-17		Accounting for sales transactions stated in a foreign currency	6	10	Medium	
Starter 16-18	W	IFRS reporting of investments	7	10-15	Easy	
E16-1		Accounting for a short-term investment	1	10-15	Easy	
E16-2		Reporting investments at fair value	1	10-15	Easy	
E16-3		Accounting for a short-term investment	1	15-20	Medium	
E16-4	W	Classifying equity investments	1,2	5-10	Easy	
E16-5		Journalizing transactions for a long-term investment	2	10-15	Easy	
E16-6		Journalizing transactions under the equity method	3	10-15	Easy	
E16-7		Recording equity-method transactions in the accounts	3	10-15	Easy	
E16-8	W	Applying the appropriate accounting method for investments	2,3	10-15	Medium	
E16-9	*	Completing a consolidation work sheet	4	20-30	Medium	

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective(s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>	<i>MyLab Pre-Test/ Post-Test</i>
		with 100 percent ownership				
E16-10		Completing a consolidation work sheet with non-controlling interest	4	20-30	Medium	
E16-11		Working with a bond investment	5	10-15	Easy	
E16-12		Recording bond investment transactions using straight-line method	5	10-15	Medium	
E16-13		Recording bond investment transactions using the effective-interest method	5	10-15	Medium	
E16-14		Calculating foreign-currency gain/loss	6	10-15	Medium	
E16-15		Journalizing foreign-currency transactions	6	10-20	Medium	
E16-16	W	Difference between ASPE and IFRS	1,2,3,5,7	10-20	Medium	
E16-17		Accounting for short-term investments, long-term investments with significant influence, and for investments in bonds	1,2,3,5	40-50	Medium	
E16-18		Analyzing long-term investments	3	10-20	Medium	
BN16-1	W	Analyzing long-term investments	4	30-45	Medium	
EI16-1	W	Ethical Issue	n/a	n/a		
P16-1A		Journalizing transactions under the fair-value and equity methods	1,2,3	25-35	Easy	
P16-2A		Applying the fair-value method and the equity method	1,2,3	45-60	Difficult	
P16-3A		Compare accounting methods as share ownership percentage varies	1,2,3	20-25	Medium	Pre-Test
P16-4A	*	Preparing a consolidated balance sheet; goodwill; no non-controlling interest	4	35-45	Medium	
P16-5A	*	Preparing a consolidated balance sheet with goodwill and non-controlling interest	4	35-45	Difficult	Pre-Test
P16-6A		Accounting for a long-term bond investment purchased at a discount	5	45-60	Difficult	
P16-7A		Computing the cost of a bond investment and journalizing its transactions using the effective-interest method of amortizing a discount	5	25-35	Difficult	Pre-Test
P16-8A		Accounting for short-term investments using the fair-value method and long-term investments in bonds	1,5	30-50	Medium	Pre-Test
P16-9A		Journalizing foreign-currency transactions and reporting the transaction gain or loss	6	30-40	Medium	
P16-1B		Journalizing transactions under the fair-value and equity methods	1,2,3	25-35	Easy	
P16-2B		Applying the fair-value method and the equity method	1,2,3	45-60	Difficult	

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective(s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>	<i>MyLab Pre-Test/ Post-Test</i>
P16-3B		Compare accounting methods as share ownership percentage varies	1,2,3	20-25	Medium	Post-Test
P16-4B	*	Preparing a consolidated balance sheet; goodwill, no non-controlling interest	4	35-45	Medium	
P16-5B	*	Preparing a consolidated balance sheet; goodwill with non-controlling interest	4	35-45	Difficult	Post-Test
P16-6B		Accounting for a bond investment purchased at a premium	5	45-60	Difficult	
P16-7B		Computing the cost of a long-term bond investment and journalizing its transactions using the effective-interest method of amortizing a discount	5	25-35	Difficult	Post-Test
P16-8B		Accounting for short-term investments using the fair-value method; investments in bonds	1,5	30-50	Medium	Post-Test
P16-9B		Journalizing foreign-currency transactions and reporting the transaction gain or loss	6	30-40	Medium	
P16-1C	W	Accounting for ownership of shares in another company	1,2,3,4	15-25	Difficult	
P16-2C	W	Accounting for foreign operations	6	10-15	Difficult	
DP16-1	W	Understanding the fair-value and equity methods of accounting for investments	1,2,3	15-20	Medium	
FSC16-1	W	Investments and foreign currency transactions	3,4,6, 7	15-20	Medium	
FSC16-2	W	Investments and foreign currency transactions	4,6	15-20	Medium	

CHAPTER 16
TEN-MINUTE QUIZ

Circle the letter of the best response.

1. Which of the features *does not* describe short-term investments?
 - A. They are recorded at cost when purchased.
 - B. Management usually intends to sell these within one year.
 - C. Stock dividends are recorded in a memorandum entry in the general journal.
 - D. They are reported at cost on the balance sheet.

2. On August 15, Prism Corporation purchased 100 shares of Western Inc. for \$52,000; the shares are considered a short-term investment for Prism Corporation. Western Inc. paid Prism Corporation \$4,000 in dividends on December 1. At year end, the shares have a market value of \$65,000. The year-end balance sheet will report a Short-term Investments value of:
 - A. \$52,000
 - B. \$56,000
 - C. \$65,000
 - D. \$69,000

3. On August 15, Metro Corporation purchased 40% of the outstanding shares of Atlantic Ltd. for \$80,000. Metro Corporation can exert significant influence on the operations of Atlantic Ltd. Atlantic Ltd. paid total dividends of \$10,000 on December 1; Metro Corporation received its share of these dividends in cash. Metro Corporation's year-end financial statements will report:
 - A. An Equity-Method Investment Revenue credit balance of \$4,000
 - B. An Investment in Atlantic Ltd. Common Shares debit balance of \$80,000
 - C. An Equity-Method Investment Revenue debit balance of \$10,000
 - D. An Investment in Atlantic Ltd. Common Shares debit balance of \$70,000

4. Which one of these statements related to consolidations is true?
 - A. Total assets of a consolidated entity are the parent company's total assets plus each subsidiary company's total assets.
 - B. When a corporation owns more than 50% of another company's shares, the parent company must report consolidated financial statements for the period.
 - C. Non-controlling interest is usually reported as an asset on a consolidated balance sheet.
 - D. Once the consolidated financial statements have been prepared, it is no longer necessary for the subsidiary company to maintain a separate set of books.

Table 16-1

On March 1, 2019, Perry Inc. purchased \$100,000 of 5%, 5-year bonds at 108.11; the bonds are purchased on their original issue date at a market interest rate of 4%. Interest is paid semiannually on March 1 and September 1. The company considers these bonds a long-term investment and uses the effective interest method to amortize any premium or discount.

5. Refer to Table 16-1. What amount of Interest Revenue would Perry Inc. record on September 1, 2019?
- \$2,000
 - \$2,162
 - \$2,500
 - \$2,703
6. Refer to Table 16-1. What is the effect of recognizing interest revenue on the carrying value of Perry's long-term investments in bonds?
- The carrying value will increase.
 - The carrying value will not change.
 - The carrying value will decrease.
 - More information is required to determine the effect.
7. Danny Corporation purchased 25% of the voting shares of Cora Inc. for \$80,000. The purchase allowed Danny Corporation to exercise significant influence over Cora Inc.'s operations. During the current year, Cora Inc. reported net income of \$100,000 while Danny Corporation reported net income of \$10,000. Which entry would Danny Corporation make related to this investment?
- | | | |
|---------------------------------------|--------|--------|
| Investment in Cora Inc. Common Shares | 25,000 | |
| Equity-Method Investment Revenue | | 25,000 |
 - | | | |
|----------------------------------|---------|---------|
| Cash | 100,000 | |
| Equity-Method Investment Revenue | | 100,000 |
 - | | | |
|---------------------------------------|--------|--------|
| Investment in Cora Inc. Common Shares | 20,000 | |
| Dividend Revenue | | 20,000 |
 - | | | |
|---------------------------------------|--------|--------|
| Investment in Cora Inc. Common Shares | 10,000 | |
| Equity-Method Investment Revenue | | 10,000 |
8. A Canadian company makes a credit purchase in Japanese yen when the exchange rate is \$0.0096 and pays for the goods when the exchange rate is \$0.0093. Which of the following statements is true?
- A hedge was created by these transactions.
 - A foreign-currency transaction gain has occurred.
 - A foreign-currency transaction loss has occurred.
 - No foreign-currency translation gain or loss has occurred.
9. Which accounting method is normally required for 100% owned subsidiaries?
- Addition method
 - Equity method
 - Fair-value method
 - Consolidation method
10. A strong Canadian dollar *discourages* which of the following?
- Travel to Canada by foreigners.
 - Purchase of foreign goods by Canadians.
 - Canadians to travel abroad.
 - Canadians to save dollars.

Answer Key to Chapter 16 Quiz

1. D 2. C 3. A 4. B 5. B 6. C 7. A 8. B 9. D 10. A