CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

Accounting Standards for Private Enterprises (ASPE) Briefing

ACCOUNTING FOR INVESTMENTS

OCTOBER 2020

Primary Standards Discussed:

- Section 1591, Subsidiaries
- Section 3051, Investments
- Section 3056, Interests in Joint Arrangements

FINANCIAL REPORTING

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This publication was originally issued in May 2016 and has been updated in June 2017 and October 2020 for amendments to the standards on accounting for investments. Readers are cautioned that certain aspects of ASPE may change after publication. (See Appendix E.)

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Acronyms

AcSB	Accounting Standards Board
ASPE	Accounting Standards for Private Enterprises
JA	Joint Arrangement
JCE	Jointly Controlled Enterprise
JCO	Jointly Controlled Operation
JCA	Jointly Controlled Asset
NFPO	Not-for-Profit Organization
PV	Present Value

PART A
Introduction and Scope

Purpose of this ASPE Briefing

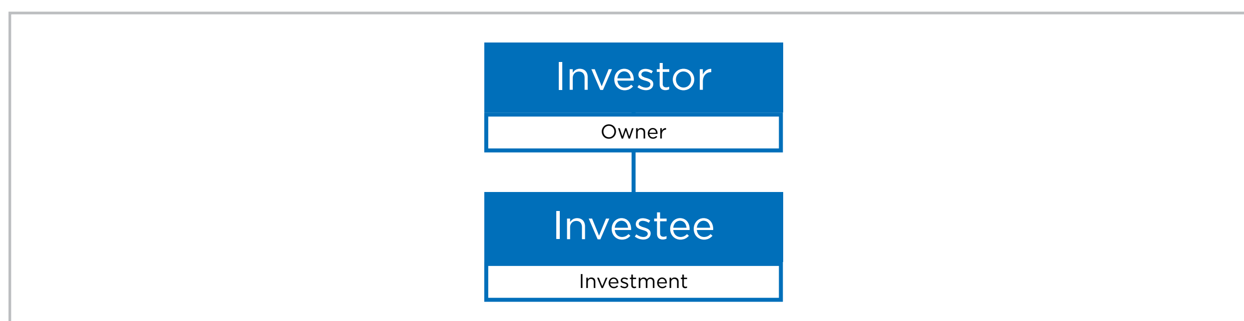
Accounting for investments can be complex because many different types of investments exist and different policy choices are available within ASPE for use when accounting for such investments. This ASPE Briefing is primarily designed to assist in the application of the following Sections in ASPE:

1. Section 1591, *Subsidiaries*
2. Section 3051, *Investments*
3. Section 3056, *Interests in Joint Arrangements*

This ASPE Briefing will:

- provide explanations on hot topics or complex areas within the standards
- answer frequently asked questions (FAQs)
- provide illustrative examples

To be consistent with the wording in the standards, the parties in an investment relationship will be referred to as the investor and investee:



Effective Dates

Sections 1591 and 3056 were first applicable to fiscal years beginning on or after January 1, 2016 and Section 3051 was first applicable to fiscal years beginning on or after January 1, 2011. Each standard has been subsequently amended since issuance and the amendments have different effective dates. This ASPE Briefing will discuss the accounting for investments based on the standards issued at October 31, 2020.

Types of Investments

Private enterprises often hold various types of investments. Some industries such as real estate development, real estate rental, construction and oil and gas are more likely to structure their activities through a number of investment vehicles. Some investments are not strategic in nature; they result instead from the investment of surplus financial resources to earn a return and should be classified as financial assets covered within the scope of Section 3856, *Financial Instruments*. Section 3856 is not covered in this ASPE Briefing.

FAQ

What are some examples of the different types of investments that can be held by a private enterprise?

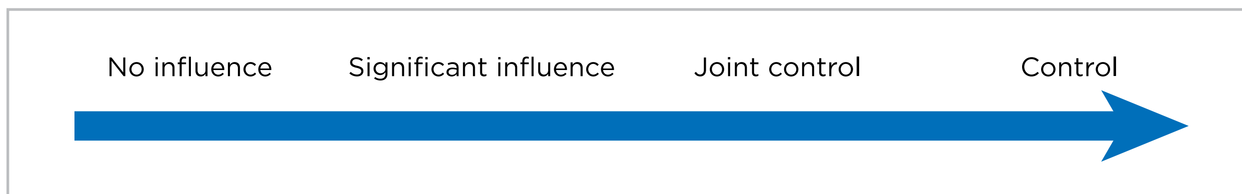
- shares of a public company
- shares of a private company
- bonds traded in the public market
- private bonds or loans receivables
- derivative instruments
- non-financial items such as works of art or other tangible assets
- joint arrangements
- partnerships
- entities controlled through a contractual arrangement

Note: The above is not an exhaustive list.

The first step in accounting for investments is to identify which investments exist (i.e., investments in equity instruments, non-financial assets, an interest through means other than equity interests in another enterprise, etc.).

The standard that should be applied to an investment depends on the degree of influence or control the investor has over the investee. Figure 1 illustrates the continuum of control, as follows:

FIGURE 1: CONTINUUM OF CONTROL



The following chart provides a summary of different investments in accordance with the continuum of control and the relevant Sections in ASPE that should be used to account for them.

Section 3856, *Financial Instruments*			**Section 3051, *Investments***		**Section 3056, *Interests in Joint Arrangements***	**Section 1591, *Subsidiaries***
Investments in equity instruments quoted in an active market without significant influence, joint control or control and derivative instruments	Investments in equity instruments not quoted in an active market without significant influence, joint control or control	Investments in other financial assets (e.g., bonds, loans receivable)	Investments subject to significant influence The policy choices for those investments subject to significant influence are discussed later in this ASPE Briefing. See Part B.	Other *non-financial* instrument investments (e.g., works of art and other tangible assets held for investment purposes)	Investments subject to joint control Categories include: • joint operations • joint assets • jointly controlled enterprises. The policy choices for the various types of interest in joint arrangements are discussed later in this ASPE Briefing. See Part D.	Controlled investments The policy choices for investments controlled through an equity investment and those controlled through contractual arrangements or other relationships are discussed later in this ASPE Briefing. See Part C.

Scope of this ASPE Briefing

The accounting for the many different classifications of investments can be complex and involves many interrelated standards. As mentioned, this ASPE Briefing will address the following standards:

- Section 1591, *Subsidiaries*
- Section 3051, *Investments*
- Section 3056, *Interests in Joint Arrangements*

This Briefing does not address investments accounted for in accordance with Section 3856, *Financial Instruments*.

Applicability to Not-for-Profit Organizations (NFPOs)

Although this ASPE Briefing will focus on private enterprises, it should be noted that some of the guidance in these standards is applicable to NFPOs.

If an NFPO uses the equity method in accordance with Section 4450, *Reporting Controlled and Related Entities by Not-for-Profit Organizations,* in Part III of the *CPA Canada Handbook – Accounting*, then Section 3051 applies. Section 4450 requires the equity method to be used by an NFPO for an investment in a significantly influenced profit-oriented enterprise. An NFPO also has an accounting policy choice to apply the equity method for an investment in:

- a controlled profit-oriented enterprise
- a joint venture

Section 3056 does not apply to NFPOs. Section 4450 was revised to include a definition of proportionate consolidation and retains the accounting previously included in the predecessor section, Section 3055. At the time of writing of this ASPE Briefing, the AcSB is working on a project to provide guidance on the initial measurement and related disclosures for combinations of not-for-profit organizations.

Outside the scope of this ASPE Briefing

This ASPE Briefing will address the following topics only to the extent that they are relevant to the accounting for certain investments:

- Section 3831, *Non-monetary Transactions*
- Section 3840, *Related Party Transactions*
- AcG-18, *Investment Companies*, which covers the accounting for investments held by investment companies (the determination of whether an enterprise is an investment company is addressed in paragraphs 8 and 9 of that Guideline)
- Section 3856, *Financial Instruments*

Summary of Main Standards Related to Investments

The following is a summary of the main guidance from each of the standards discussed in this ASPE Briefing and how they are interrelated:

Topic	Section 3051, *Investments*	Section 3056, *Interests in Joint Arrangements*	Section 1591, *Subsidiaries*
Type of investment	Provides guidance on the accounting for any investment where the investor has significant influence over the investee. The following accounting methods may be applied: • the cost method • equity method Also provides guidance on works of art and other tangible assets held for investment	Provides guidance on the accounting for joint arrangements where joint control exists Depending on the type of joint arrangement, the following accounting methods may be applied: • cost method (refers back to Section 3051) • equity method (refers back to Section 3051) • recognition of the interest in the individual assets, obligations, revenue and expenses of the joint arrangement	Provides guidance on the accounting for investments where control exists The following accounting methods may be applied: • cost method • equity method (refers back to Section 3051) • consolidation (refers back to Section 1601, *Consolidated Financial Statements*)
Applicability	Applicable to: • investments in equity instruments of others subject to significant influence • investments in a jointly controlled enterprise (JCE) when the equity or cost method is applied in accordance with Section 3056 • investments in a subsidiary when the equity or cost method is applied in accordance with Section 1591	Applicable to ALL joint arrangements: • jointly controlled assets • jointly controlled operations • jointly controlled enterprises (see also Section 3051 if accounting policy choice of cost or equity method is selected)	Applicable to ALL subsidiaries including those controlled through: • voting interests • means other than equity interests (e.g., contractual arrangements) (see also Section 3051 if accounting policy choice of cost or equity method is selected) Remember: A subsidiary may take many forms, including a corporation, trust, partnership or unincorporated enterprise

Topic	Section 3051, *Investments*	Section 3056, *Interests in Joint Arrangements*	Section 1591, *Subsidiaries*
Guidance on accounting for contributions and transactions between investor and investee	Addresses the accounting for contributions and transactions between investor and investee	Addresses the accounting for contributions and transactions between investor and investee (See paragraphs 3056.19-.26 for JCOs and JCAs, and 3056.33 for JCEs) Refers back to Section 3051 when the equity or cost method is applied	Refers back to Section 1601, *Consolidated Financial Statements* when consolidation is applied or Section 3051, *Investments* for subsidiaries using the equity method
Impairment	Addresses accounting for impairment (See paragraphs 3051.23-.27)	Addresses accounting for impairment for jointly controlled assets or jointly controlled operations and refers to Section 3064, *Goodwill and Intangible Assets* and Section 3063, *Impairment of Long-Lived Assets* as appropriate guidance Refers back to Section 3051 when the equity or cost method is applied to a jointly controlled enterprise to avoid unnecessary duplication of the guidance on impairment, which is found in Section 3051 (see Background Information and Basis for Conclusions paragraph 31)	Refers back to Section 3051 when the cost or equity method is applied Not applicable when consolidation is applied
Gains/losses on sale	Addresses accounting for gains and losses on sale of an investment (See paragraphs 3051.28-.30)	Refers back to Section 3051 when the equity or cost method is applied to an investment in a JCE Also addresses potential sale of a JCE: An interest in a JCE that is intended for disposal continues to be recognized in the financial statements of the investor until such time as the investor ceases to have joint control over the JCE. The provisions of Section 3475, *Disposal of Long-lived Assets and Discontinued Operations* would apply when the specified criteria are met. (See paragraph 3056.32)	Refers back to Section 3051 when the equity or cost method is applied

Topic	Section 3051, *Investments*	Section 3056, *Interests in Joint Arrangements*	Section 1591, *Subsidiaries*
Presentation	Addresses presentation issues (See paragraphs 3051.31-.33)	Addresses what items must be presented separately on the income statement and balance sheet (See paragraphs 3056.34-.36)	See Sections 1601 and/or 3051, as applicable
Disclosure	Addresses disclosure (See paragraphs 3051.34-.38)	Addresses disclosure Also refers to disclosures in Section 3280, *Contractual Obligations*; Section 3290, *Contingencies* and Section 3840, *Related Party Transactions* (See paragraphs 3056.37-.42) Refers back to Section 3051 for disclosure when the equity or cost method is applied	Addresses disclosure The requirements are different depending on the nature of the financial statements: • consolidated financial statements • non-consolidated financial statements (See paragraphs 1591.32-.38)

PART B
Section 3051, *Investments*

Scope

Investments within the scope of Section 3051 include (see paragraphs 3051.01-.03):

- investments subject to significant influence
- other non-financial instrument investments (e.g., works of art and other tangible assets held for investment purposes)
- investments in subsidiaries where the investor is applying the equity method
- interests in joint arrangements categorized as a JCE where the investor is applying the cost or equity method

Investments outside the scope of Section 3051:

- consolidated subsidiaries
- interests in joint arrangements where the investor is not applying the cost or equity method as a policy choice
- financial instruments within the scope of Section 3856, *Financial Instruments*
- investments held by investment companies which are within the scope of AcG-18, *Investment Companies*
- biological assets within the scope of, Section 3041, *Agriculture*

Significant Influence

Section 3051 discusses significant influence as follows (see paragraph 3051.05):

> Significant influence differs from control and joint control (see SUBSIDIARIES Section 1591, and INTERESTS IN JOINT ARRANGEMENTS, Section 3056). An investor may be able to exercise significant influence over the strategic operating, investing and financing policies of an investee even when the investor does not control or jointly control the investee. For example, the ability to exercise significant influence may be indicated by representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel or provision of technical information. If the investor holds less than 20 percent of the

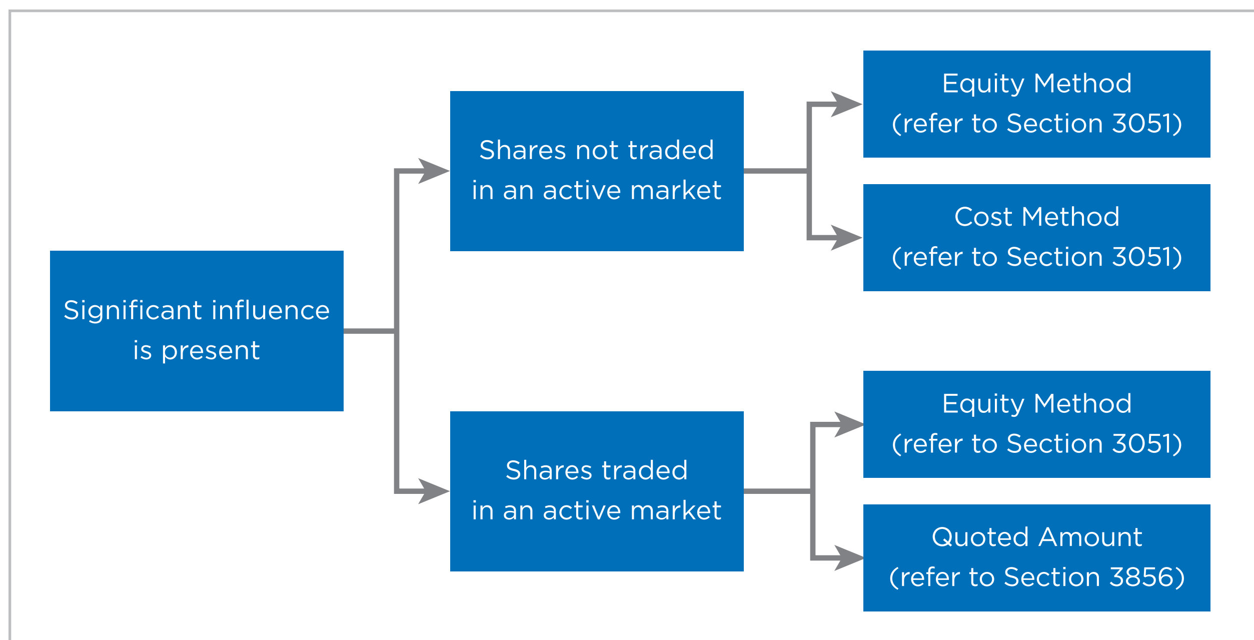
voting interest in the investee, it is presumed that the investor does not have the ability to exercise significant influence, unless such influence is clearly demonstrated. On the other hand, the holding of 20 percent or more of the voting interest in the investee does not in itself confirm the ability to exercise significant influence. A substantial or majority ownership by another investor would not necessarily preclude an investor from exercising significant influence.

If the investor does not exercise significant influence, control or joint control, the investment in the investee will be accounted for as a financial instrument in accordance with Section 3856, *Financial Instruments*.

Accounting Methods When Significant Influence Is Present

Section 3051 provides an accounting policy choice to account for investees when the investor has significant influence. The investee may be accounted for using either the cost method or equity method. All investments subject to significant influence must be accounted for using the same policy choice.

If the investee's equity securities are quoted in an active market, the cost method cannot be used; the accounting policy choice is between the equity method and the investee's quoted amount. The policy choices for investments subject to significant influence are summarized as follows:



Reminder: Applying the cost or equity method is a policy choice for investments subject to significant influence, investments in JCEs, and investments in subsidiaries. The guidance in Section 3051 may be applicable to different types of investment. To be clear: there is a separate policy choice for (a) investments subject to significant influence, (b) JCEs and (c) subsidiaries. Therefore, different choices can be made for each; however, the same choice must be made within each of the three categories.

Equity method

Paragraph 3051.04(a) defines the **equity method** as follows:

> The equity method is a basis of accounting for investments whereby the investment is initially recorded at cost and the carrying value is adjusted thereafter to include the investor's pro rata share of post-acquisition earnings of the investee, computed by the consolidation method. The amount of the adjustment is included in the determination of net income by the investor, and the investment account of the investor is also increased or decreased to reflect the investor's share of capital transactions and changes in accounting policies and corrections of errors relating to prior period financial statements applicable to post-acquisition periods. Profit distributions received or receivable from an investee reduce the carrying value of the investment.

In addition to investments subject to significant influence, the equity method can also be used to account for:

- subsidiaries; however, the measurement of cost to account for subsidiaries falls within the scope of Section 1591
- JCEs as permitted by Section 3056 (see paragraph 3056.29(b))

FAQ

Based on the above definition of the equity method, the phrase "computed by the consolidation method" is used. What does that mean?

In essence the term "computed by the consolidation method" means that the equity method requires similar adjustments when calculating the "equity pick-up" or adjustment as those that would occur if consolidation accounting were applied.

Specifically, paragraph 3051.11 requires the depreciation and amortization of the investee's assets be based on the assigned costs of such assets at the date of acquisition of the investee (i.e., the fair value on the acquisition date) rather than the amount at which the assets are recorded on the investee's balance sheet. However, the portion of the difference between the investor's cost and the amount of its underlying equity in the net assets of the investee that is similar to goodwill (equity method goodwill) is not amortized.

(See also paragraphs 3051.12-.13)

FAQ

How does accounting for partnerships fit in?

A partnership is a vehicle or structure, and not a category of accounting, although some often refer to the matter as "accounting for partnerships". The appropriate accounting will depend on the nature of the partnership and the degree of influence or control the investor has over the partnership. It could be appropriate to apply the cost method, equity method, consolidation or to account for it as an interest in a joint arrangement representing rights to the individual assets and obligations for the individual liabilities relating to a JA.

The equity method is summarized as follows:

- **Initial Measurement** of the investee – at cost
- **Subsequent Measurement** of the investee
  - Adjusted thereafter to include the investor's pro rata share of post-acquisition earnings of the investee, computed by the consolidation method
  - Reduced by the investor's proportion of dividends subsequently paid by the investee
- **Measurement of income** from the investee – the investor's share of the income or losses of the investee, computed by the consolidation method

When there is an indication of impairment of an investee, the investor must determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the investment. Some discussion on impairment is included later in this ASPE Briefing.

Cost method

Section 3051.04(b) defines the cost method as follows:

> The **cost method** is a basis of accounting for investments whereby the investment is initially recorded at cost; earnings from such investments are recognized only to the extent received or receivable (see paragraph 3051.04(b)).

The cost method is the simplest method to account for an investee and generally means the amount paid or payable for the investment (or the fair value measurement of the consideration for a non-monetary transaction). In addition to investments subject to significant influence, the cost method can also be used to account for:

- subsidiaries; however, the measurement of cost to account for subsidiaries falls within the scope of Section 1591
- JCEs as permitted by Section 3056 (see paragraph 3056.29(b))
- Other investments

Initial Measurement

- Cost is measured at the acquisition-date fair value of the consideration transferred, including measurement of any contingent consideration.
- When an investment subject to significant influence is acquired by an exchange of only equity interests, the acquisition-date fair value of the investee's equity interests may be more reliably measurable than the acquisition-date fair value of the enterprise's equity interests. If so, the enterprise must determine the fair value of the consideration transferred by using the acquisition-date fair value of the investee's equity interests instead of the acquisition-date fair value of the enterprise's equity interests transferred.
- When an interest subject to significant influence is acquired in two or more transactions, at the same or different dates, the cost of the investment is the sum of the cost of the separate transactions, and would include any transaction costs that may have been capitalized as part of the first transaction in accordance with Section 3856.
- The acquisition of an investment will generally involve some transaction costs. These range from a simple brokerage fee on a market-purchase of equity securities, to the significant legal and accounting fees that can be involved in more complex acquisition transactions. Acquisition costs, sometimes referred to as "transaction costs" which are incurred at acquisition are recognized as an expense. The exceptions to expensing these items are for costs to issue debt and equity securities and any transaction costs capitalized in accordance with the previous paragraph (see Section 3856, *Financial Instruments* and Section 3610, *Capital Transactions*).

Subsequent Measurement

Subsequent measurement of the investee is the same as initial measurement unless the investment is impaired. When there is an indication of impairment, an investor must determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the investment.

Although a full discussion of the impairment of investments is beyond the scope of this ASPE Briefing, there is some discussion on impairment later in this ASPE Briefing.

Investees quoted in an active market – use of quoted amount

Section 3051 and other Sections of ASPE define fair value as follows:

> **Fair value** is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act (see paragraph 3051.04(d)).

All investments accounted for under Section 3856 are initially recorded at fair value. Section 3856 requires that equity instruments traded in an active market and derivatives be subsequently measured at fair value. It would be inconsistent to have interests in subsidiaries and investments subject to significant influence measured using the cost method if they are

traded in an active market. Therefore, controlled or significantly influenced investments that are traded in an active market cannot be accounted for using the cost method but may be accounted for at their quoted amounts or by using the equity method.

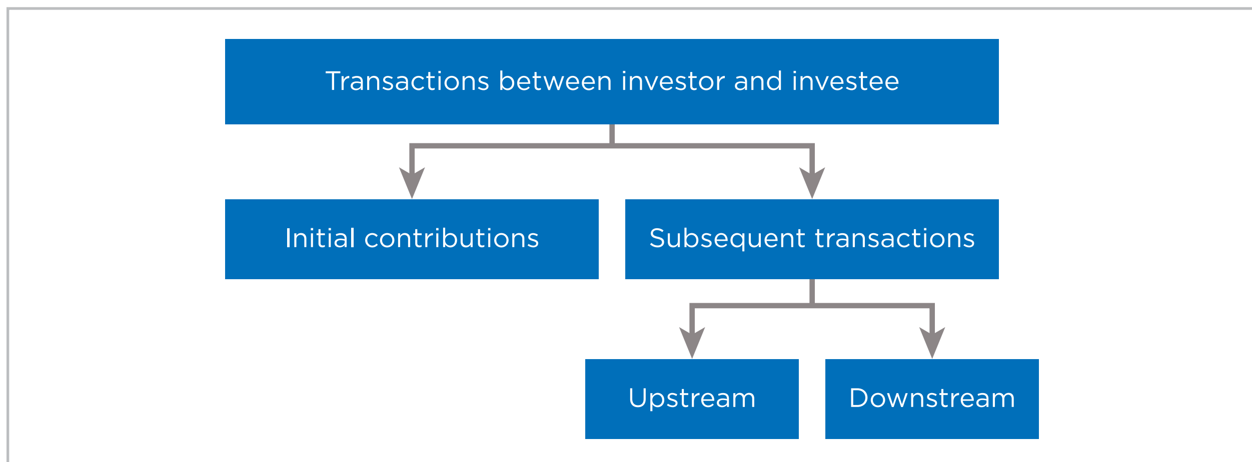
Transactions Between the Investor and Investee

Transactions between the investor and the investee fall into two main categories:

- initial contributions by the investor
- subsequent transactions between the investor and investee

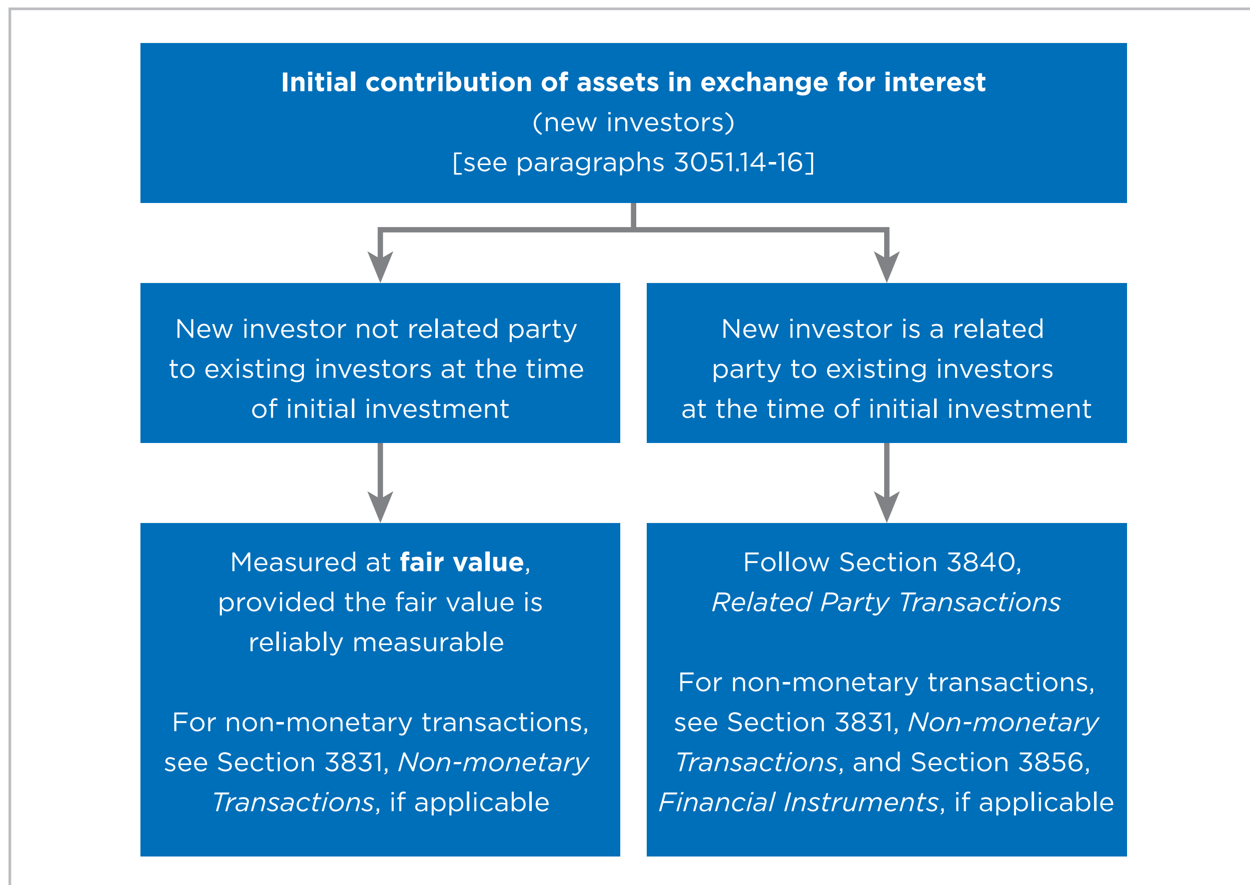
If the equity method is used, the accounting for subsequent transactions can be more complex than the cost method since the subsequent transactions must be identified as either "upstream" (i.e., transactions where investee sells assets to the investor) or "downstream" (i.e., transactions where the investor sells assets to the investee).

The following chart summarizes the different types of transactions between the investor and investee:



Initial contributions

If the initial contributions are in the form of cash there is little complexity. However, in some instances the contributions are tangible and intangible assets — with or without cash. Furthermore, at times, the new investor and existing investors are related parties before the arrangement is formulated. Therefore, as can be seen in the following chart, multiple standards may need to be reviewed to determine how to account for the initial contributions:



Appendix C of this ASPE Briefing provides some examples of the initial contribution to a joint arrangement.

Subsequent transactions

Because subsequent transactions between the investor and investee are related party transactions, the accounting follows the guidance in Section 3840, *Related Party Transactions* and Section 3831, *Non-monetary Transactions*, if applicable.

The following chart summarizes the accounting for subsequent transactions between the investor and investee that occur in the normal course of operations and are therefore measured at the exchange amount in accordance with Section 3831:

Topic	Investor Sells Assets to Investee "Downstream"	Investor Purchases Assets from Investee "Upstream"
Nature of transaction	An investor sells assets to an equity-accounted investee in the normal course of operations	An investor purchases assets in the normal course of operations from an equity-accounted investee

Topic	Investor Sells Assets to Investee “Downstream”	Investor Purchases Assets from Investee “Upstream”
Accounting treatment	Any gain or loss shall be recognized in income at the time of the sale to the extent of the interests of the other non-related investors	The investor shall not recognize its share of the profit or loss of the investee on the transaction until the assets are sold to a third party

When an investor sells an asset to an investee in the normal course of operations and the transaction provides evidence of a reduction in the net realizable value or a decline in the carrying amount of the relevant asset, the investor shall recognize this decline by writing down that portion of the asset retained through its interest in the equity-accounted investee and recognize the full amount of any loss in income.

If a subsequent transaction between the investor and investee is not in the normal course of operations or does not represent a substantive change in ownership, the transaction is measured at carrying amount. No gain or loss is recorded.

Appendix D provides some examples of transactions between the investor and investee using the equity method.

Impairment

Paragraph 3051.23 provides guidance on the need to assess investments for impairment:

> At the end of each reporting period, an investor shall assess whether there are any indications that an investment may be impaired. When there is an indication of impairment, an investor shall determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the investment.

Reminder: The impairment assessment applies to all investments accounted for under the cost and equity methods.

The following indicators of impairment are included in paragraph 3051.24:

- significant financial difficulty of the investee
- it is becoming probable that the investee will enter bankruptcy or other financial reorganization
- the disappearance of an active market for shares of the investee because of financial difficulties
- a significant adverse change in the technological, market, economic or legal environment in which the investee operates, or in the market to which an asset is dedicated (e.g., a sharp decline in the price of a commodity that may cause economic instability in the investee’s industry)

- an acquisition of an additional interest or sale of a portion of an interest in an investee for consideration paid or received that is less than the proportionate share of the carrying amount of the interest in an investee immediately before the acquisition or sale
- a dilution in an investor's interest in an investee that indicates the expected amount of future cash flows from holding or selling the investment is less than the carrying amount of the investment immediately before the dilution

The following general reminders are provided:

- when an impairment is determined to exist, the investment can be written down directly or by using an allowance
- any impairment loss is recorded in net income
- an impairment loss must be reversed if conditions change

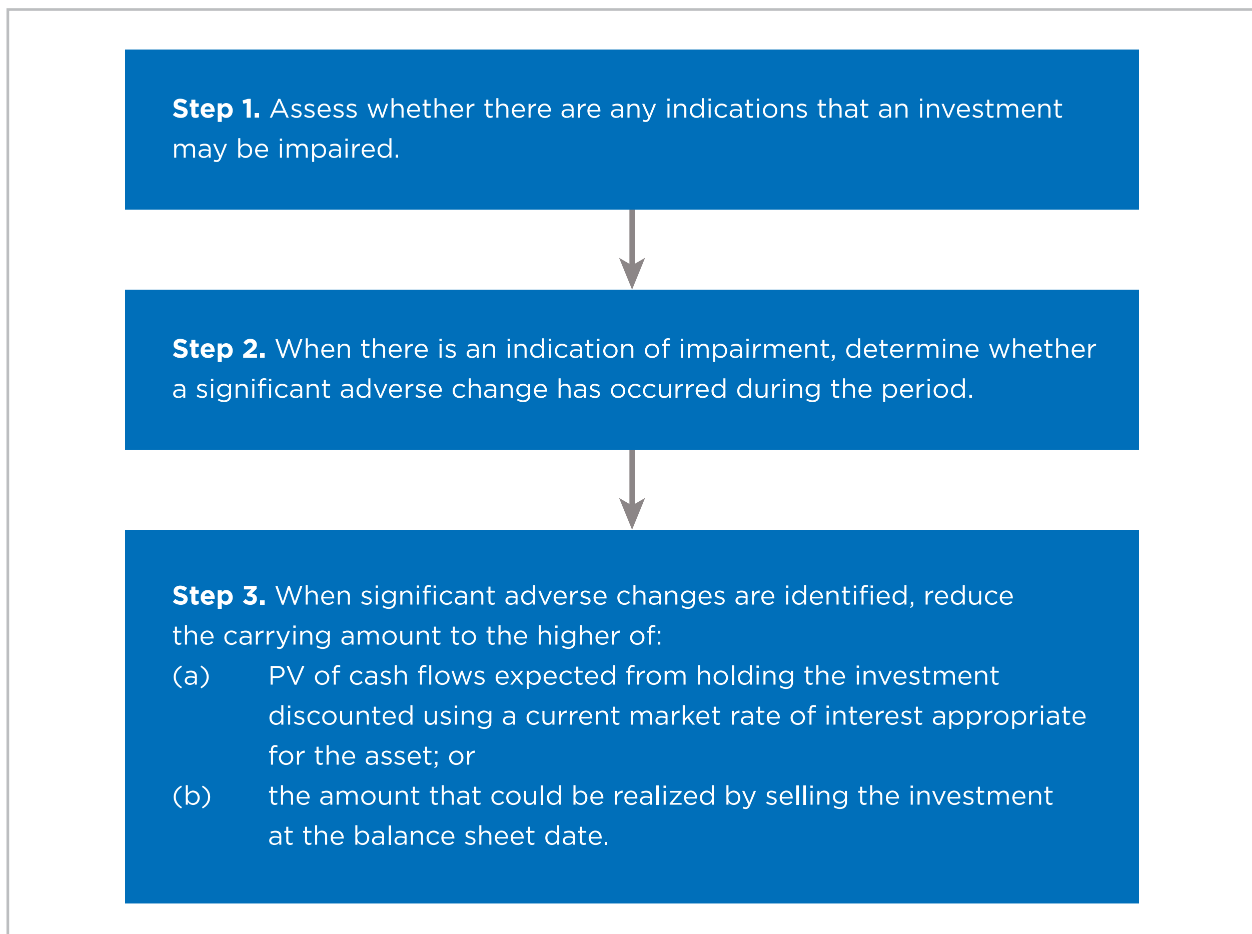
COVID-19 as an Example of a Significant Adverse Change

An example of a significant adverse change in the market might be the COVID-19 pandemic in 2020. Some questions under such circumstance may include:

- Has the industry or region that the investee or its customers operate in faced significant negative impacts due to COVID-19?
- Does the investee have (or is it expected to have) significant reductions in cash flows?
- Does the investee have sufficient financing, including lines of credit?
- Has the investee breached debt covenants, or is it likely to do so in the future?
- Does the investee have any obligations that may be onerous, including guarantees, in respect of third parties?
- Has the market for the investee's products or services been significantly reduced?
- Does the investee face supply chain difficulties or other factors that are likely to reduce output below normal levels?
- If the investee is a publicly quoted company, is there still an active market for its shares?

The above are examples of impairment considerations and are not meant to be an exhaustive list. Judgment is required when evaluating how long the pandemic and its impact(s), along with any related government measures, will affect the investee and how quickly the investee will recover.

The following steps summarize the guidance on impairment in paragraphs 3051.23-.27:



Presentation and Disclosure

Section 3051 provides guidance on the presentation of investments in the balance sheet (see paragraph 3051.31) and income statement (see paragraph 3051.32) and points out the following:

> A significant factor in evaluating the investment income is the relationship of the income reported to the investments from which such income is derived. For this reason, investments reported in the balance sheet and investment income reported in the income statement are grouped in the same way (see paragraph 3051.33).

The specific disclosure requirements are provided in paragraphs 3051.34-.38. Information on interests in significant investments should be provided as well as the method used to account for investments. Disclosure of any impairments and fair values of equity investments quoted in an active market should also be made. Additional disclosures are required when the fiscal periods of the investor and investee are different.

PART C

Section 1591, *Subsidiaries*

An interest in a subsidiary can be created by subscribing to the common shares of a new enterprise, purchasing a controlling interest in the shares of an existing enterprise (see Section 1582, *Business Combinations*) or through a contract or other means that conveys control.

Paragraph 1591.03 provides the following definitions:

> **Subsidiary** is an enterprise controlled by another enterprise (the parent) that has the right and ability to obtain future economic benefits from the resources of the enterprise and is exposed to the related risks (see paragraph 1591.03 (a)).
>
> **Control** of an enterprise is the continuing power to determine its strategic operating, investing and financing policies without the co-operation of others (see paragraph 1591.03 (b)).

FAQ

What does "continuing power" mean in the definition of control?

Generally, "continuing power" means that the power is uninterrupted. However, judgment must be used to reach such a conclusion. As indicated in paragraph 1591.12 a "brief interruption of the power to determine strategic policies is not a loss of control. For example, a receiver appointed pursuant to a default by a subsidiary under a loan arrangement with a third party may seize a specific asset in satisfaction of the loan but permit the subsidiary to continue in business under the direction of the parent."

Substantive Rights

As indicated above, control is determined based on the continuing power to determine an entity's strategic operating, investing and financing policies. Control may result from equity ownership, or the right to elect the majority of the board of directors. It may also be obtained by other rights, such as contractual arrangements or ownership of financial instruments convertible to equity. Any such rights must be substantive. (i.e., the holder has the practical ability to exercise that right resulting in control). Amendments to Section 1591

in December 2018 provide clarity regarding the assessment as to whether the right is "substantive". (The amendments to paragraphs 1591.14 and new paragraphs 1591.14A-.14D apply to annual financial statements relating to fiscal years beginning on or after January 1, 2021, with early application permitted.)

The determination of substantive rights requires significant judgement. Section 1591.14B lists the following factors to consider in making the determination of whether an entity's rights provide it with the substantive right to control:

- Whether there are any barriers (economic or other) that prevent the holder (or holders) from exercising the rights. Examples of such barriers include but are not limited to:
  - financial penalties and incentives that would prevent (or deter) the holder from exercising its rights;
  - an exercise or conversion price that creates a financial barrier that would prevent (or deter) the holder from exercising its rights;
  - terms and conditions that make it unlikely that the rights would be exercised, for example, conditions that narrowly limit the timing of their exercise;
  - the absence of an explicit, reasonable mechanism in the founding documents of a subsidiary or in applicable laws or regulations that would allow the holder to exercise its rights;
  - the inability of the holder of the rights to obtain the information necessary to exercise its rights;
  - operational barriers or incentives that would prevent (or deter) the holder from exercising its rights (e.g., the absence of other managers willing or able to provide specialized services or provide the services and take on other interests held by the incumbent manager); or
  - legal or regulatory requirements that prevent the holder from exercising its rights.
- When the exercise of rights requires the agreement of more than one party, or when the rights are held by more than one party, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so. The lack of such a mechanism is an indicator that the rights may not be substantive. The more parties that are required to agree to exercise the rights, the less likely it is that those rights are substantive.

The following chart highlights questions to help determine whether an entity's rights are considered substantive:

Question	Answer
Are there are any barriers to exercise the rights?	When there are significant barriers placed in a manner to challenge the entity's ability to exercise its rights (as listed in Section 1591.14B), the rights may not be substantive. Any entity must consider any financial penalties, operating barriers, legal barriers, etc. in making this determination.

Question	Answer
Does the right need to be exercised by a large or "collective" group of investors?	The larger the number of parties required to agree on the decision to exercise their rights, the less likely the rights are substantive. This is true unless there is a formal process in place that will enable the parties to exercise their rights.
Are the rights currently exercisable?	The standard states that, generally speaking, in order for a right to be substantive, the holder must have the current ability to exercise those rights.
Will the holder benefit from exercising their rights?	Are the rights "in the money" or will the holder be able to obtain operational efficiencies or any synergies because of exercising the rights?

The following example illustrates the determination of whether an investor's rights are substantive or not.

Entities A and C currently hold the following ownership interests in XYZ Company:

- Entity A has a 25% ownership interest in XYZ Company
- Entity C has a 75% ownership interest in XYZ Company

Fact Pattern 1A
Entity A has an in-the-money call option to acquire all of the shares held by Entity C (75% interest). The option is currently exercisable; however, Entity A is in financial distress and does not have the financial ability to exercise the option.

Fact Pattern 1B
Entity A has an in-the-money call option to acquire all of the shares held by Entity C (75% interest). The option is currently exercisable and Entity A has the financial ability to exercise the option.

Are Entity A's rights "substantive"?

Analysis

Fact Pattern 1A
Entity's A's rights are likely not substantive since it has significant barriers that would challenge its ability to exercise the option (Section 1591.14B). In this case, Entity A would not consolidate XYZ Company.

Fact Pattern 1B
Entity's A's rights are likely substantive since it does not have any significant barriers that would challenge its ability to exercise the option (Section 1591.14B). In this case, Entity A would consolidate XYZ Company.

Section 1591 provides additional guidance regarding whether rights need to be currently exercisable. Noting that, while it is generally required that a right be currently exercisable, it is possible for a right that is not currently exercisable to be considered substantive.

The following example illustrates the determination of whether a right that is not currently exercisable is a substantive right.

Consider the following ownership structure:

- Entity J has a 25% ownership interest in TXV Company
- Entity K has a 35% ownership interest in TXV Company
- Entity L has a 40% ownership interest in TXV Company

All decisions regarding the relevant activities for TXV Company are generally voted on at the annual general meeting by majority vote. Alternatively, decisions regarding relevant activities can also be determined through a "special meeting" at the request of any of the individual shareholders. If such a meeting is called, the shareholder agreement stipulates that the special meeting must occur within 30 days.

Entity K (35% interest) has an in-the-money call option to acquire all of the shares held by Entity J (25% interest). The option is in the form of a forward contract that is exercisable 10 days from now. Entity K has the financial means to exercise their option, and no other significant barriers exist (as set out in Section 1591.14B).

Are Entity K's rights "substantive"?

Analysis
Entity K's rights are substantive, despite the forward contract not being currently exercisable. Since the forward contract enables Entity K to purchase an additional 25% ownership interest, that right would result in Entity K owning the majority of the shares.

Entity K can exercise its option prior to any decisions about the direction of the strategic operating, investing or financing policies (which can only be made at an AGM or special meeting).

As noted above, substantive rights relate to the ability of an investor to direct the relevant activities of an investee. Those rights could include the current ability to approve or block decisions relating to those relevant activities as long as the rights are not "protective" as explained in paragraph 1591.14D:

> Substantive rights exercisable by other parties can prevent a party from controlling another party to which those rights relate. Such substantive rights do not require the holders to have the ability to initiate decisions. As long as the rights are not merely protective (see paragraph 1591.21), substantive rights held by others may prevent one party from controlling the other party even if the rights give the holders only the current ability to approve or block decisions that relate to the relevant activities.

The following factors may help distinguish between protective and substantive rights.

Substantive Rights

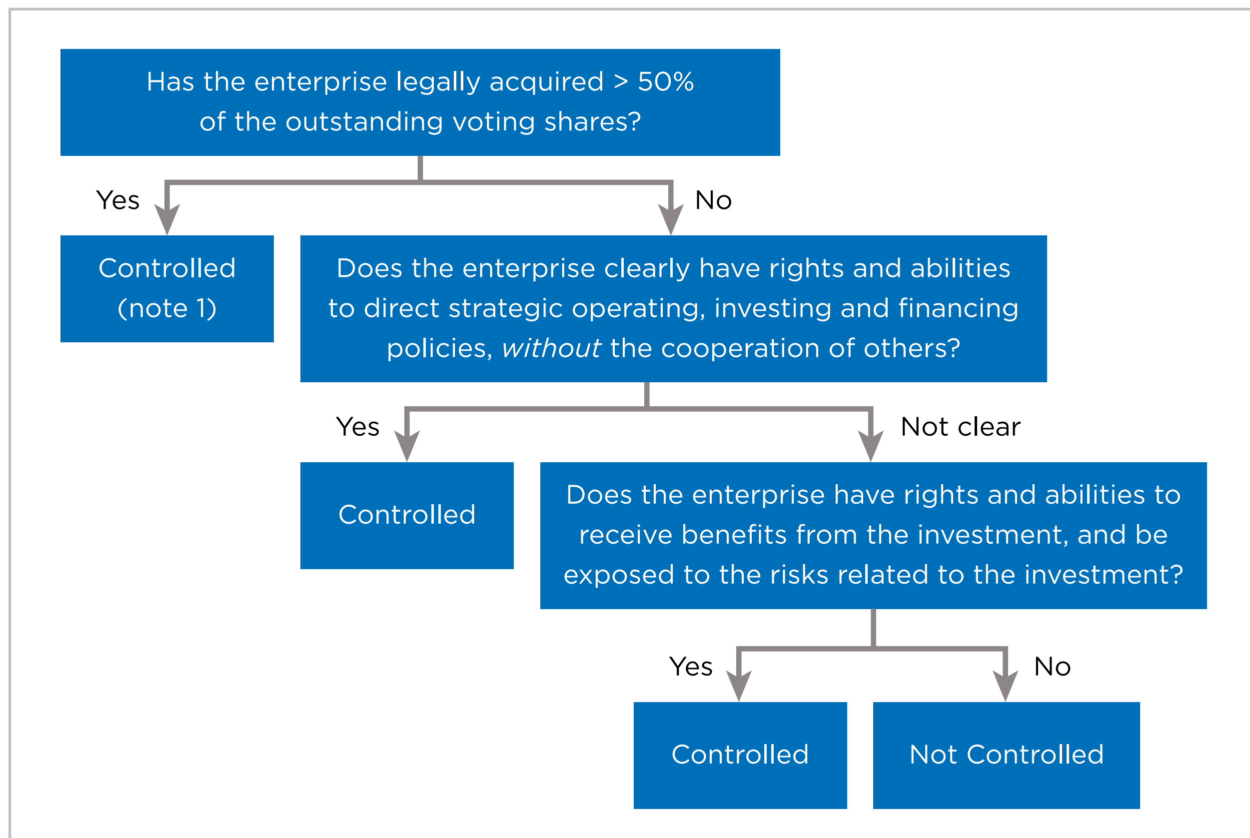
- Provide the right to prevent another investor from obtaining control.
- Voting rights that enable the majority investor to individually and unilaterally direct the relevant activities of the investee.
- The right by the non-controlling interest to approve or block decisions that relate directly to the investee's relevant activities.

Protective Rights

- Rights held by the non-controlling interest to approve or block decisions about significant changes outside of the ordinary course of business (i.e., significant capital outlay, issuance of new debt).
- Rights held by a lender in the event of default (i.e., on a loan), whereby the lender can seize assets held as collateral.

Control

The following decision tree provides guidance on the assessment of whether control exists. The sufficiency of rights and abilities, however, must still be determined, including substantive rights.



Note 1: An enterprise is presumed to control another enterprise when it owns, directly or indirectly, an equity interest that carries the right to elect the majority of the members of the other enterprise's board of directors. These presumptions may be overcome by other factors (see paragraph 1591.09)

Refer to paragraphs 1591.16-.23 when applying this guidance.

FAQ

What is an example of control through means other than an equity interest?

An example would be a franchisor who, through the franchise contract, has "the continuing power to determine the franchisee's strategic operating, investing and financing policies without the co-operation of others".

FAQ

What does the scope exclusion related to contractual arrangements between enterprises under common control mean to me (see paragraph 1591.02(f))?

Contractual arrangements may sometimes seem to imply control between enterprises under common control. For example, a holding company owns an operating company and the primary shareholder of the holding company also owns a real estate company. There is a lease agreement between the operating company and real estate company or the real estate company and the holding company. The operating company is a subsidiary of the holding company. The question that may arise is whether the real estate company should be considered a subsidiary of the holding company or the operating company since the primary shareholder controls all the enterprises, directly or indirectly. However, since the enterprises are under the common control of the primary shareholder, it is not necessary to consider whether the holding company (or the operating company) should consolidate the real estate company.

In most small business structures, the probability of identifying a subsidiary controlled through a contractual arrangement where common control does not exist would be low.

FAQ

Are the common control exemption in Section 1591 (see paragraph 1591.02(f)) and the scope exception for related parties (see paragraph 1591.30 -.31) addressing the same concern?

No. The scope exemption at the beginning of Section 1591 makes it clear that the requirements in the standard are not applied to accounting for contractual arrangements between enterprises under common control. If the investor is preparing consolidated or non-consolidated financial statements, the investor reports its rights and obligations related to an enterprise under common control in accordance with the applicable Section (e.g., if the contractual agreement which confers control is a lease, then Section 3065 would apply).

Paragraphs 1591.30 and .31 apply to transactions between entities that are not under common control but are related parties. For example, if Company A owns 30% of Company B and 20% of Company C, then Company B and Company C are related parties, but not under common control.

As mentioned, control is a matter of fact but requires significant effort to assess as it is a key issue. If control exists, there is an accounting policy choice to be made as to how the subsidiary should be accounted for. A key consideration in the policy choice is often the cost of the subsequent accounting. For example, the cost to prepare consolidated financial statements does not always exceed the benefits, if any, to the users of the financial statements.

Section 3840 applies to intercompany transactions that would otherwise have been eliminated on consolidation when non-consolidated financial statements are prepared, and control is exercised through voting interests or potential voting interests. The requirements of Section 3840 do not apply to non-consolidated financial statements where control is exercised through means other than voting interests, potential voting interests or a combination thereof.

Section 3856 also applies to intercompany transactions that would otherwise have been eliminated on consolidation when non-consolidated financial statements are prepared.

Scope

Section 1591, *Subsidiaries*, as the name implies, addresses the accounting for subsidiaries (i.e., those investments where control exists). Its main guidance is on the assessment of control; the actual accounting for the investment is addressed in other standards. As a result, Section 1591 is closely related to the following Sections:

- Section 1582, *Business Combinations*, which sets out the basis of accounting when control over a business is acquired
- Section 1601, *Consolidated Financial Statements*, which describes the preparation of consolidated financial statements and also deals with combined financial statements.
- Section 1602, *Non-controlling Interests*, which describes the accounting for a non-controlling interest in a subsidiary subsequent to the subsidiary's acquisition.
- Section 3051, *Investments*, which describes the accounting for subsidiaries where the cost or equity method is selected.

Section 1591 applies to interests in other entities; the following exceptions are outside the scope of Section 1591:

- Accounting for investments covered by other Sections (see Section 3051, *Investments,* Section 3056, *Interests in Joint Arrangements* and Section 3856, *Financial Instruments*).
- Accounting by investment companies (see Accounting Guideline (AcG-18), *Investment Companies*).
- Employer's accounting for an employee benefit plan subject to the provisions of Section 3462, *Employee Future Benefits*.
- Accounting for a qualifying special-purpose enterprise by a transferor of financial assets or its affiliates, as set out in Appendix B of Section 3856. A transferor reports its rights and obligations related to the qualifying special-purpose enterprise according to the requirements of Section 3856.
- Accounting for an enterprise's interests in a qualifying special-purpose enterprise, unless that enterprise has the unilateral ability to cause the enterprise to liquidate or to change the enterprise so that it no longer meets the conditions set out in Appendix B of Section 3856. If the enterprise is not consolidated, the enterprise reports its rights and obligations related to that enterprise in accordance with the applicable Section.
- Accounting for contractual arrangements between enterprises under common control. In its consolidated or non-consolidated financial statements, each such enterprise reports its rights and obligations related to another enterprise under common control in accordance with the applicable Section (e.g., Section 3065, *Leases*).

Recognition and Presentation

In general terms, a subsidiary exists when the investor has control over the other enterprise. There are in essence two types of subsidiaries:

1. those controlled by way of an equity interest (including consideration of other factors, not just the number of votes)
2. those controlled through contractual arrangements

Paragraph 1591.24 indicates that an enterprise makes an accounting policy choice to:

a. consolidate **ALL** its subsidiaries

OR

b. prepare non-consolidated financial statements and:
   i. account for investments controlled through voting interests, potential voting interests or a combination thereof using either the cost or equity method
   AND
   ii. account for investments controlled through contractual arrangements according to the nature of the contractual arrangements in accordance with the applicable Section (e.g., Section 3065, *Leases*, etc.)
   iii. account for investments controlled through voting interests, potential voting interests, or a combination thereof, in combination with contractual arrangements by accounting for the equity portion using the cost or equity method, and the contractual arrangements in accordance with the applicable Section (e.g., Section 3065, *Leases*, etc.).

This means that, if consolidation is selected, it must be done for ALL subsidiaries regardless of how control arises.

Reminder: Fair value is used rather than cost if the investment is in equity securities traded in an active market (see paragraph 1591.26).

The existence of control in a particular situation is a question of fact. The guidance in Section 1591 provides some indication of the factors to be considered, including substantive rights, in determining whether control exists in specific situations (see paragraphs 1591.11-.23).

The Cost Method for Subsidiaries

Section 1591 provides guidance on how to apply the cost method for subsidiaries as follows:

Initial measurement

- Cost is measured at the acquisition-date fair value of the consideration transferred, including measurement of any contingent consideration.
- When an investment in a subsidiary is acquired by an exchange of only equity interests, the acquisition-date fair value of the investee's equity interests may be more reliably measurable than the acquisition-date fair value of the enterprise's equity interests. If so, the enterprise must determine the fair value of the consideration transferred by using the acquisition-date fair value of the investee's equity interests instead of the acquisition-date fair value of the enterprise's equity interests transferred.
- When an investment in a subsidiary is acquired in two or more transactions, at the same or different dates, the cost of the investment is the sum of the cost of the separate transactions.
- When an enterprise and the subsidiary have a pre-existing relationship or other arrangement that existed before negotiations for the acquisition of the subsidiary began, or enters into an arrangement during the negotiations that is separate from the acquisition of the subsidiary, including the remuneration of employees or former owners of the acquiree for future services or reimbursement of the acquiree or its former owners for paying the acquirer's acquisition-related costs, then the requirements in Section 1582, *Business Combinations*, is applied.
- Acquisition costs incurred are recognized as an expense, except for costs to issue debt and equity securities (see Section 3856, *Financial Instruments* and Section 3610, *Capital Transactions*).
- A bargain purchase gain on the purchase of a subsidiary is not recognized.
- A previously held investment is not remeasured in a step acquisition.
- If the initial accounting for a subsidiary is incomplete by the end of the reporting period in which the acquisition occurs because of, for example, a working capital adjustment clause, the carrying amount must include a provisional amount. Section 1591 addresses the accounting for any provisional amounts in subsequent periods.

Subsequent periods

- Recognize earnings from subsidiaries only to the extent received or receivable.
- At the end of each reporting period, the requirements on impairment in Section 3051 must be applied.
- Contingent consideration must be remeasured when the contingency is resolved, on the same basis as required by Section 1582.

- The provisional carrying amount, if any, of the interest in the subsidiary is to be adjusted in the period in which the provisional amounts are finalized and this measurement period must not exceed one year from the acquisition date.
- If the ownership interest in a subsidiary increases or decreases in subsequent periods (i.e., purchase or sale of a portion of the interest or dilution), the accounting for the increase/decrease is summarized as follows:

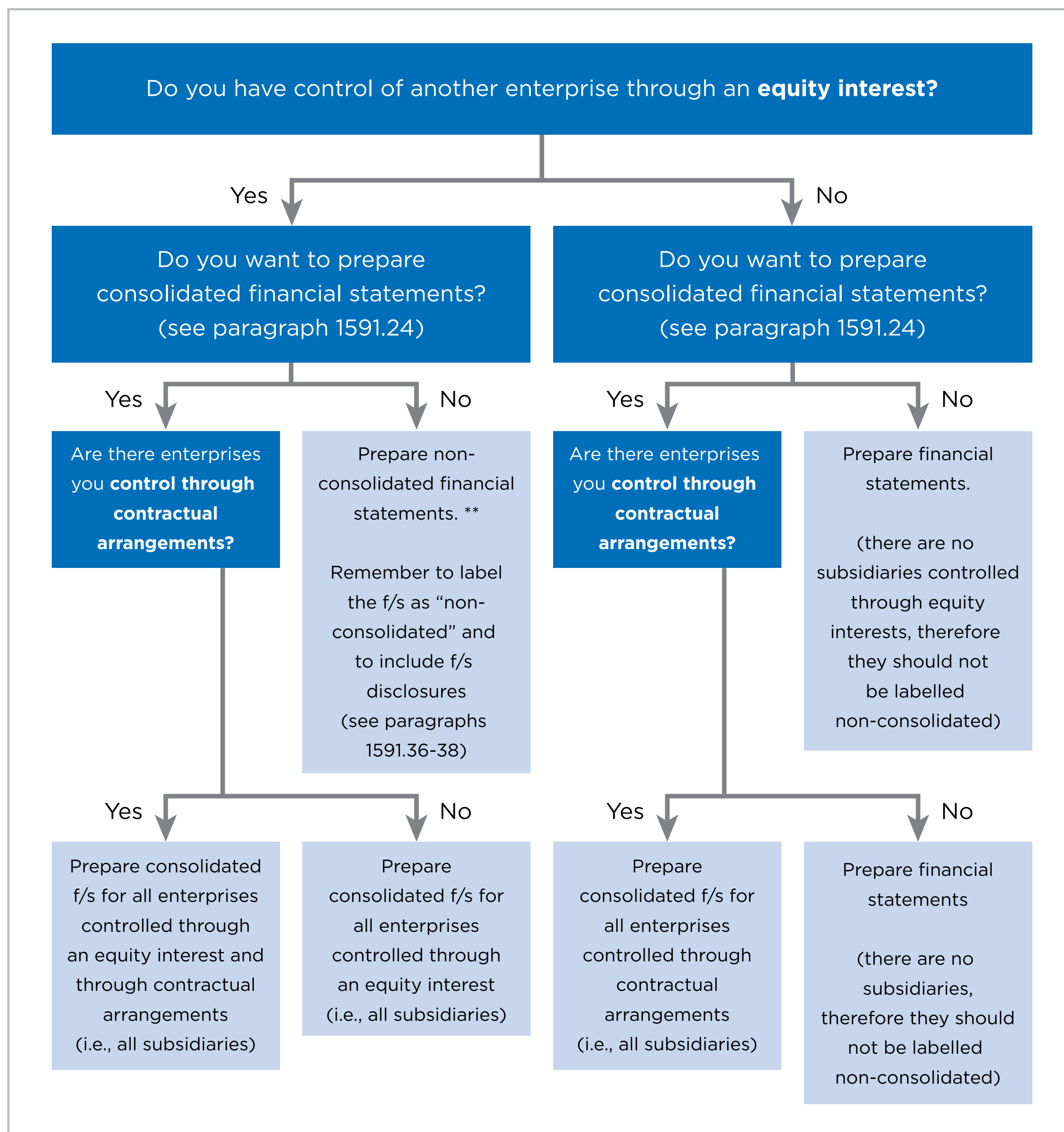
Increase in Ownership Interest	Decrease in Ownership Interest
The acquisition of an additional ownership interest is measured at cost, and the original interest is not remeasured. Therefore, the cost of a subsidiary is the carrying amount of the interest in the subsidiary immediately before the (additional) acquisition plus the cost of any additional interest acquired.	When an enterprise sells a portion of its interest in a subsidiary, the retained interest should be measured as a proportionate share of the carrying amount of the subsidiary immediately prior to the reduction in interest.

Section 3051 requires a gain or loss resulting from a dilution of an enterprise's investment to be recognized when the equity method is used but not when the cost method is used. To be consistent with this approach, the AcSB concluded that an enterprise accounting for a subsidiary using the cost method should not be required to recognize a gain or loss resulting from dilution.

Disclosures

Disclosures related to non-consolidated financial statements using the cost or equity method are included in 1591.36 to .38.

The following decision tree illustrates the decisions and related references in Section 1591. The decision tree creates two branches by asking whether control of another enterprise exists through an equity interest. The branch on the left addresses situations where a subsidiary exists through an equity interest and consolidated financial statements are being considered. The branch on the right addresses situations where control may exist by means other than equity interests.



** You do not need to assess whether you control other enterprises through means other than equity interests.

Measurement

FAQ

How do I consolidate when an enterprise (the subsidiary) is controlled through rights other than equity interests?

The subsidiary's assets and liabilities are measured at fair value on the day control is acquired (in accordance with Section 1582, *Business Combinations*) and consolidated with the parent, and a non-controlling interest is measured at 100% (or less if you own an equity interest) of the net book value of the subsidiary.

Disclosure

The disclosure requirements depend on whether the financial statements are consolidated or not. The references are provided below:

Consolidated financial statements	Non-consolidated financial statements
Paragraphs 1591.32-.35 **Note:** Disclosures required by other standards would also apply (e.g., if the contractual agreement which confers control is a lease, the disclosures in Section 3065 apply).	Paragraphs 1591.36-.38

PART D

Section 3056, *Interests in Joint Arrangements*

Scope

Section 3056 establishes standards for investments in arrangements in which the investor has joint control. Note that Section 3056 deals with the accounting by the investor and does not deal with accounting by the joint arrangement itself.

What Is a Joint Arrangement Under Section 3056?

Paragraph 3056.03(c) provides the following definition:

> A **joint arrangement** is an economic activity resulting from a contractual arrangement whereby two or more investors jointly control the economic activity.

It should be noted that Section 3056 does not use the term "joint venture." The key is to understand the nature of the arrangement as a JCA, JCO or JCE. A contract or other material may refer to the arrangement as a joint venture, but its substance will determine how it should be classified.

The key factor is the assessment of joint control, which is defined in paragraph 3056.03(b) as follows:

> **Joint control** of an economic activity is the contractually agreed sharing of the continuing power to determine its strategic operating, investing and financing policies.

FAQ

Does joint control require that there be unanimous consent among the investors?

A few respondents to the Exposure Draft noted that the definition of joint control in IFRS 11 Joint Arrangements requires unanimous consent of the parties, whereas the notion of unanimous consent is absent in Section 3056. Therefore, they suggested that the concept of "unanimous consent" from IFRS 11 be added to the definition of joint control in Section 3056. However, the AcSB was concerned that adding the concept of unanimous consent to Section 3056 could inadvertently change the application of the concept of joint control, which was not the intention of this project. Therefore, the AcSB agreed to undertake research at a future time on the definition of joint control as a separate project.

Paragraph 3056.05 also addresses the possibility that an arrangement may exist without entitling all the investors to share in joint control. For example, assume Investor A and Investor B each has a 40% interest in the joint arrangement and Investor C has 20%. In addition, assume the joint agreement requires 75% consent on decisions. In this case, Investors A and B have joint control as all decisions require their agreement. Investor C has a passive investment because its consent is not required in making decisions. Investor C therefore accounts for its interest in accordance with Section 3051 or Section 3856.

Section 3056 applies to those investments that meet the criteria of a joint arrangement regardless of what it is actually referred to in any underlying agreements or documentation (e.g., the documentation may use terms such as joint venture, partnership, corporation, trust, etc.).

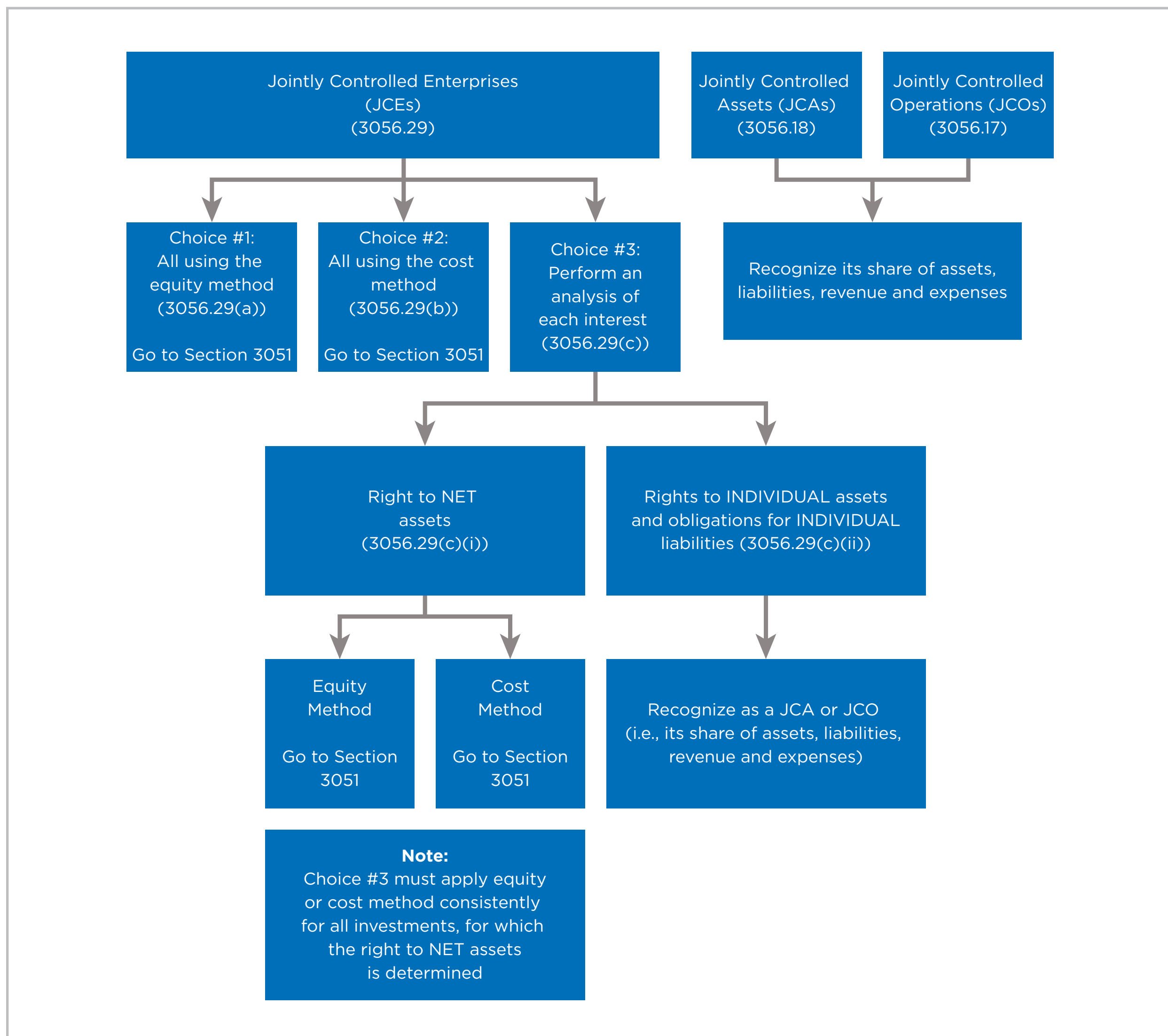
In addition, Section 3056 does not apply when economic activities do not meet the definition and criteria of a joint arrangement even though they may sometimes be referred to as joint arrangements or joint ventures. The accounting for investments is governed by the nature of the investments.

Three Types of Joint Arrangements

The legal structure and the terms within all related agreements must be reviewed to determine the nature of the arrangement. Based on the facts and circumstances of each arrangement, the substance of the arrangement may be different than its legal form. The features of the three types of joint arrangements under Section 3056 are summarized as follows:

Jointly Controlled Assets (JCAs)	Jointly Controlled Operations (JCOs)	Jointly Controlled Enterprises (JCEs)
Arrangement to **share the use** of assets only. The investor has rights to the individual assets and obligations for the individual liabilities relating to the JCA	Arrangement to **share the operations**—revenue and expenses. The investor has rights to the individual assets and obligations for the individual liabilities incurred by the JCO	Arrangement to **share a separate enterprise**. The investor has rights to the net assets of the JCE
Involves the joint control (and often the joint ownership) by the investors of one or more assets contributed to or acquired for the purposes of the joint arrangement and dedicated to the purposes of the joint arrangement (See paragraphs 3056.12-.13)	Involves the use of the assets and other resources of the investors (i.e., not a corporation, partnership or other enterprise, or a financial structure separate from the investors themselves) The assets (e.g., property, plant and equipment; inventories; etc.) remain under the ownership and control of each investor. Each investor also incurs its own expenses and liabilities and raises its own financing, which represents its own obligations. (See paragraphs 3056.10-.11)	Involves the establishment of a corporation, partnership or other enterprise in which each investor has an interest (See paragraphs 3056.14-.15)
Example: The sharing of a jointly controlled warehouse, or a jointly controlled rental property	**Example:** The sharing of the operations when one party has the building and the other has equipment and labour force	**Example:** An enterprise is created and the investors have an investment in the net equity of the JCE that owns and operates a warehouse
Represents an investment in an asset (i.e., building)	Represents an investment in the net assets of the warehouse operations	Represents an investment in the net equity of the separate enterprise

Summary of the Types of Joint Arrangements and Accounting Methods



As indicated in the above summary, there are three choices for the accounting for a JCE, which are discussed below:

Choice #1: If an investor uses the equity method to account for a JCE, the guidance for the equity method is found in Section 3051, *Investments* discussed in Part C of this ASPE Briefing.

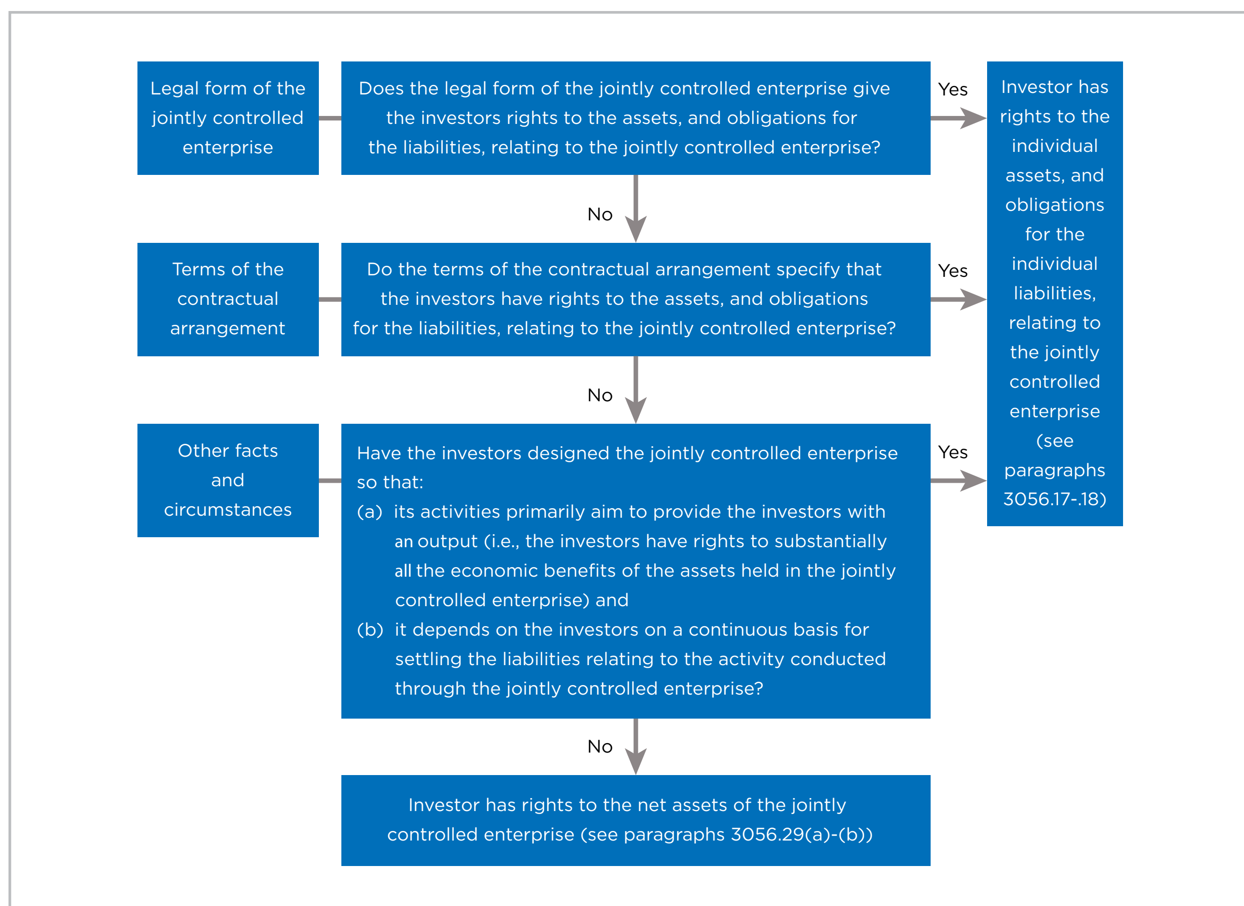
Choice #2: If an investor uses the cost method to account for a JCE, the guidance for the cost method is found in Section 3051, *Investments*.

Choice #3: Section 3056 recognizes that the substance of a joint arrangement may be that the investor has an interest in the individual assets and liabilities of a JCE rather than in the net assets. It therefore provides an "additional analysis option" to determine the substance of the arrangement. Each JCE would be assessed separately.

Interests in a JCE that the analysis shows to be, in substance, interests in the individual assets and liabilities must be accounted for as such rather than by the cost or equity methods permitted in Choices #1 and #2.

Although the legal form of the arrangement is relevant in assessing whether the investor has a right to the net assets or individual assets and liabilities of the JCE, there are other factors to be considered. The decision tree from paragraph 3056.A11 is useful for the performance of the analysis of each interest:

DECISION TREE—CLASSIFICATION OF AN INVESTOR'S INTEREST IN A JOINTLY CONTROLLED ENTERPRISE



The accounting treatment for *each* interest after this analysis is as follows:

- If the right is to **net assets**, then apply either the equity or cost method consistently for all such interests.
- If the right is to **individual assets and liabilities**, then recognize the investor's share of assets, liabilities, revenue and expenses.

In performing the additional analysis option, the terms within all related contractual agreements must be reviewed to determine the substance of the arrangement. Paragraph A5 of Appendix A in Section 3056 provides guidance on common terms in contractual arrangements and whether the arrangement does provide the investor with a right to the net assets of a JCE or a right to the individual assets and obligations for the individual liabilities of a JCE. Each arrangement is unique; the analysis is based on the facts and circumstances of the specific agreement and arrangement.

FAQ

A policy choice exists under Section 3056 to perform an analysis to determine whether the interest in the JCE represents a right to net assets or a right to the individual assets and obligations. Why would I select to perform the analysis?

The standard does not require the analysis in Choice #3 because, in most cases, the result of the analysis will show that there is an interest in the net assets. Requiring this analysis for all JCEs would not meet a cost/benefit test. However, where the interest in a JCE is in substance an interest in individual assets and the obligation is for individual liabilities, then Choice #3 permits an enterprise to present the individual assets and liabilities in their financial statements rather than use the cost or equity method if it thinks it provides more useful information to users.

However, as previously noted, most JCEs are an interest in net assets and must be accounted for using the cost or equity method.

Contributions and Transactions

The guidance on contributions to and transactions with JCOs and JCAs is discussed in Section 3056 (see paragraphs 3056.19-.26).

The guidance on contributions to and transactions with JCEs depends on the accounting option selected for the JCE.

- If the investor uses the equity method to account for the joint arrangement, contributions and transactions are accounted for in accordance with Section 3051, *Investments*. The accounting for contributions and transfers when the enterprise uses the equity method is discussed in Part D of this ASPE Briefing. Examples are provided in Appendices C and D.
- If the investor accounts for the interest in the joint arrangement as an interest representing rights to the individual assets and obligations for individual liabilities, contributions and transactions are accounted for in accordance with the guidance for JCOs and JCAs in paragraphs 3056.19-.26 mentioned above (see paragraph 3056.33).

Presentation and Disclosure

Section 3056 provides guidance on the presentation of joint arrangements in the balance sheet (see paragraph 3056.34) and the income statement (see paragraph 3056.35) and points out the following in paragraph 3056.36:

> A significant factor in evaluating the investment income is the relationship of the income reported to the investments from which such income is derived. For this reason, investments reported in the balance sheet and investment income reported in the income statement are grouped in the same way.

Specifically, these investments are grouped using the following categories:

- Subsidiaries and interests in joint arrangements accounted for using the equity method
- Subsidiaries and interests in joint arrangements accounted for at cost
- Investments in companies subject to significant influence
- Other investments accounted for at cost

The specific disclosure requirements are provided in paragraphs 3056.37-.42. Information on interests in significant joint arrangements should be provided as well as disclosures required by:

- Section 3280, *Contractual Obligations*
- Section 3290, *Contingencies*
- Section 3840, *Related Party Transactions*

The method used to account for an interest in a JCE should also be disclosed.

For joint arrangements accounted for using the cost or equity method, the disclosures required by Section 3051, *Investments* must also be met.

Since Section 3056 may result in the application of the equity method, a non-complex example of the application of this method is included in **Appendix B** of this ASPE Briefing.

APPENDIX A

Examples of the Cost Method

This appendix provides examples of the accounting for an investment in equity shares using the cost method.

Examples of where use of the cost method may be appropriate, assuming the equity shares of the investee are **not traded in an active market**, include:

- When the investor is able to exercise significant influence over the investee – the cost method is an accounting policy choice under Section 3051 (see Example 1 below).
- When the investor controls the investee – the cost method is an accounting policy choice; however, the measurement of cost to account for the investee falls within the scope of Section 1591 (see Example 2 below).
- When the investor has joint control over the investee – the cost method is an accounting policy choice to account for the JCE as permitted by Section 3056 (no example provided).
- When the investor is not able to exercise significant influence (Section 3051) (no example provided).

Example 1: Using the cost method when accounting for an investment subject to significant influence

Initial recognition and measurement

Cost of an investment is measured based on the acquisition date fair value of the consideration transferred, including measurement of any contingent consideration.

The acquisition of an investment will generally involve some transaction costs. These costs can range from a simple brokerage fee on the purchase of equity securities to significant legal and accounting fees incurred on more complex transactions. Acquisition-related costs, sometimes referred to as transaction costs, are recognized as an expense.

Subsequent measurement

Earnings from investments using the cost method are recognized only to the extent received or receivable. This means that income from dividends are usually recorded when declared by the investee.

When the cost method is used, the investment is initially measured at cost and, in most circumstances, remains at this value as long as the investment is retained by the investor. An exception to this general rule occurs when the investment becomes impaired. When there are indications of impairment, an investor must determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows. In this situation, Section 3051 requires the investment to be written down to the higher of:

- the present value of the cash flows expected to be generated by holding the investment
- the amount that could be realized by selling the investment at the balance sheet date

The facts:

- Company A purchased 4,000 shares (40%) of Company B's common stock on January 2, 20X2, for $200,000 in cash.
- Assume there is no contingent consideration or transaction costs.
- Company B's 20X2 net income is $80,000.
- Company B paid total dividends on December 1, 20X2 of $20,000 ($2 per share).

The following journal entries illustrate the accounting for the investment by Company A:

January 2, 20X2		
Investment in Company B	$200,000	
Cash		$200,000
To record the acquisition of the shares in Company B.		

December 1, 20X2		
Cash	$8,000	
Investment income		$8,000
To record receipt of 40% of Company B's $20,000 of dividends paid.		

This example is developed further in Appendix B applying the equity method.

Example 2: Using the cost method when accounting for an investment in a subsidiary

The facts:

- On December 31, 20X1, ABC Company purchased 100% of the outstanding voting shares of DEF Company for $1 million in cash. On that date, the carrying value of the net identifiable assets of DEF was $1.5 million. All DEF's identifiable assets and liabilities had fair values equal to their carrying values, except for land which had a fair value in excess of its carrying value of $400,000.
- ABC incurred transaction costs of $100,000 upon acquisition of DEF.
- ABC agreed to pay the previous shareholders of DEF 20% of the net income of DEF for three years subsequent to acquisition.

- There were no intercompany transactions other than dividend payments during the three years subsequent to December 31, 20X1. Dividends were declared on November 1 of each year and paid on December 31, of the same year.

Initial recognition and measurement

In order to measure the investment, some assumptions are made about the contingent liability (the future amounts payable to the former shareholders of DEF). Assume the expected net income of DEF is as follows:

Year	Expected Net Income
20X2	$2,000,000
20X3	1,000,000
20X4	3,000,000
Total	**$6,000,000**

DEF's actual net income and dividends declared and paid in each of the three years are as follows:

Year	Actual Net Income	Dividends
20X2	$2,000,000	$1,500,000
20X3	500,000	400,000
20X4	3,400,000	1,700,000
Total	**$5,900,000**	**$3,600,000**

The journal entries to record ABC's investment in DEF for the years 20X1 through 20X4 are as follows:

December 31, 20X1		
Investment in DEF ($1,000,000 + $1,102,924 (Note 1)	$2,102,924	
Cash		$1,000,000
Contingent liability on investment of DEF (Note 1)		1,102,924
To record the acquisition of DEF.		

Note 1: The estimated fair value of the contingent consideration, discounted at an assumed rate of 4%, is calculated as follows:

Expected Net Income	Portion of Income to be Paid		PV of Contingent Consideration
$2,000,000	20%	$400,000	$384,615
1,000,000	20%	200,000	184,911
3,000,000	20%	600,000	533,398
			$1,102,924

Journal entries – Year 1

December 1, 20X2		
Cash	$1,500,000	
Investment income		$1,500,000
To record receipt of the DEF $1,500,000 dividend.		
Interest expense	$44,147	
Contingent liability on investment of DEF		$44,147
To record accretion expense (Note 2).		
Contingent liability on investment of DEF	$400,000	
Cash		$400,000
To record payment of the contingency amount (actual earnings of $2,000,000 * 20% = $400,000).		

Journal entries – Year 2

December 1, 20X3

	Debit	Credit
Cash	$400,000	
Investment income		$400,000
To record receipt of the DEF $400,000 dividend.		
Interest expense	$29,882	
Contingent liability on investment of DEF		$29,882
To record accretion expense (Note 2).		
Contingent liability on investment of DEF	$100,000	
Cash		$100,000
To record payment of the contingency amount (actual earnings of $500,000 * 20% = $100,000).		
Contingent liability on investment of DEF	$100,000	
Gain on contingent liability		$100,000
To record the reduction of the liability (as net income of DEF was lower than expected).		

Journal entries – Year 3

December 1, 20X4

	Debit	Credit
Cash	$1,700,000	
Investment income		$1,700,000
To record receipt of the DEF $1,700,000 dividend.		
Interest expense	$23,077	
Contingent liability on investment of DEF		$23,077
To record accretion expense (Note 2).		
Contingent liability on investment of DEF	$680,000	
Cash		$680,000
To record payment of the contingency amount (actual earnings of $3,400,000 * 20% = $680,000).		
Loss on contingent liability	$80,000	
Contingent liability on investment of DEF		$80,000
To record the increase in the liability (as net income of DEF was higher than expected).		

Note 2: For simplicity, this example does not consider other remeasurements, changes in discount rates, or any possible impairment of the investment in DEF.

In accordance with paragraph 1591.26B(d), changes in the provisional carrying amount of the interest in a subsidiary recognized by the acquirer after the acquisition date may be the result of additional information obtained about facts and circumstances that existed at the acquisition date (and if known, would have affected the initial measurement of the interest in the subsidiary). Such changes are considered measurement period adjustments. This measurement period cannot exceed one year from the acquisition date.

Additional information about facts and circumstances existing after the acquisition date (i.e., meeting an earnings target) are not considered measurement period adjustments. Therefore, DEF accounts for changes in the fair value of the contingent consideration in the period when the contingency is resolved, with any gain or loss recognized in net income.

APPENDIX B

An Example of the Equity Method

In accordance with the definition of the equity method, the amount of the investor's pro rata share of post-acquisition earnings of the investee, is computed by the consolidation method. The following example will provide a non-complex illustration of the equity method as a refresher for the concepts only. Assume all amounts are material since the example is for illustration purposes.

The facts:

- Company A purchased 4,000 shares (40%) of Company B's common stock on January 2, 20X2, for $200,000.
- Assume there is no contingent consideration or transaction costs.
- Company B's 20X2 net income is $80,000.
- Company B paid dividends in 20X2 of $20,000 ($2 per share).
- Total shareholders' equity of Company B on January 2, 20X2 is $300,000. Company B's land with a book value of $50,000 has a fair value of $120,000. Its other capital assets have a net book value of $300,000 and a fair value of $350,000. The estimated remaining useful life of these other capital assets is 10 years. The fair value of the remaining identifiable assets and liabilities approximated book value on January 2, 20X2. The net book value of the remaining identifiable assets and liabilities is a net liability of $50,000.

The following computations illustrate the carrying amount of the investment at the end of the period for Company A.

Computations for the Application of the Equity Method Applied by the Investor

Step 1: At acquisition, determine excess of purchase price over book value of net assets acquired:

Investment in 40% of the shares of Company B	$200,000
40% of the book value of net assets acquired (40% of $300,000)	120,000
Excess of purchase price over book value of net assets acquired	$80,000

Step 2: Company A allocation of purchase price of Company B:

Purchase price	$200,000
Net assets of Company B at book value	$120,000
Additional amount assigned to land (($120,000 - $50,000 = $70,000) × 40%)	28,000
Additional amount assigned to other capital assets (($350,000-$300,000 = $50,000) × 40%)	20,000
Value of net assets acquired	168,000
Goodwill	$32,000

Step 3: Company A's equity in the earnings of Company B is calculated as follows:

Income of Company B	$80,000
Share of income ($80,000 × 40%)	$32,000
Additional depreciation ($50,000 × 40% = $20,000/10 year life)	(2,000)
Equity pickup	$30,000

Investment, beginning of year	$200,000
Equity pickup	30,000
Dividends (4,000 × $2)	(8,000)
Investment, end of year	$222,000

Alternative calculation:

Investment	$200,000
+ Income $80,000 × 40%	32,000
- Dividends ($20,000 × 40%)	(8,000)
- Depreciation ($50,000/10 × 40%)	(2,000)
Investment, end of year	$222,000

APPENDIX C

Examples of Initial Contributions for a Jointly Controlled Enterprise (JCE)—Accounted for Using the Equity Method

Initial Contribution of Capital Assets

Example 1—The accounting by the investor in a JCE for a contribution of capital assets with a carrying value < (less than) fair value and the treatment of a gain (ignoring income taxes).

On January 1, Tortly Ltd. (TL) entered into a joint arrangement agreement with two other unrelated corporations. A new corporation was set up and classified as a JCE. TL contributed capital assets with a fair value of $723,000 and a carrying value of $487,000. In return, TL received a one-third interest in the JCE and $123,000 in cash. Each of the other investors contributed $50,000 in cash and capital assets with a fair market value of $550,000. The JCE arranged a bank loan for $350,000 in order to finance its cash requirements.

Accounting for this transaction by TL under Sections 3051 (equity accounting) and Section 3056:

The portion of the gain on the transfer of assets attributable to the other investors is included in income and calculated as follows:

Calculation of the Gain on Transfer of Capital Assets at January 1

Fair value of capital assets transferred by TL to JCE	$723,000
Carrying amount on TL's books	487,000
Full gain on transfer of capital assets to JCE	$236,000

Allocation of gain	
Gain attributable to TL's remaining interest in the JCE (1/3)	$78,667
Gain attributable to the investors' remaining interest (2/3)	157,333
	$236,000

The journal entry to be recorded by TL is as follows:

Account	Debit	Credit
Investment in JCE	$521,333	
Cash	123,000	
Gain on transfer of capital assets to JCE		$157,333
Capital assets (carrying value)		487,000

TL's investment in JCE is calculated as follows: $723,000 less cash of $123,000 less TL's gain of $78,667 as the gain is only recognized to the extent of the other investors (see paragraph 3051.14). The gain attributable to the portion of the assets transferred that TL still has as an interest in (as a result of its interest in the JCE (i.e., 1/3 * $78,667)) is amortized to income on the same basis as the related capital asset (now in JCE), increasing the investment balance.

Note: Under Sections 3051/3056 the fact that the JCE arranged for financing does not change the recording of this transaction.

Example 2—The accounting by the investor in a JCE for a contribution of capital assets with a carrying value > (greater than) fair value and the treatment of a loss (ignoring income taxes)

On January 1, as its capital contribution to a JCE, Gravel Ltd. (GL) contributed capital assets with a fair value of $480,000 and a carrying value of $840,000. In return, GL received a 25% interest in the JCE and $380,000 in cash.

The capital assets are not written down to fair value prior to the transfer. (**Reminder:** This situation can occur because the impairment test for capital assets makes the assessment by comparing the net recoverable amount to the carrying amount, not the fair value.)

Scenario A

In Scenario A, there is sufficient evidence of a decline in the carrying value of the capital assets.

Assuming the transaction provides evidence of a decline in the carrying value of the asset, 100% of the loss is recognized.

Under paragraph 3051.14 the required journal entry is as follows:

Account	Debit	Credit
Investment in JCE (FV of asset $480,000 – cash of $380,000)	$100,000	
Loss [(100%) ($480,000 – $840,000)]	360,000	
Cash	380,000	
Capital assets (carrying value)		$840,000

Scenario B

In Scenario B, there is insufficient evidence of a decline in the carrying value of the capital assets.

When there is insufficient evidence of a decline in the carrying value of the capital assets, only 75% of the loss is recognized.

Calculation of the Loss on Transfer of Capital Assets as at January 1

Fair value of capital asset transferred by GL to JCE	$480,000
Carrying amount on GL's books	840,000
Full loss on transfer of capital assets to JCE	($360,000)

Allocation of loss	
Loss attributable to the portion of GL's remaining interest in the JCE (1/4)	$90,000
Loss attributable to the other investors' remaining portion (3/4)	270,000
Full loss on transfer of assets to JCE	$360,000

As a result, the capital asset is being transferred at a value of $570,000 [FV $840,000 – (75% of the loss of $360,000 or $270,000)]. This means the investment in the joint arrangement will be recorded at $190,000 ($570,000 – less the cash received of $380,000).

Under paragraph 3051.14 the required journal entry is as follows:

Investment in JCE	$190,000	
Loss [(75%) ($480,000 – $840,000)]	270,000	
Cash	380,000	
Capital assets (carrying value)		$840,000

Note: 25% of the loss will be recognized as the asset is depreciated.

APPENDIX D

Examples of Transactions Between Investor and Investee—Accounted for Using the Equity Method

The following example will serve to illustrate the application of the equity method when various consolidation adjustments are required.

On December 31, 20X1, B Ltd. (B) acquires 40% of the voting shares of C Inc. (C) for $400,000. At that time, the carrying value of C's net assets was $900,000. All the assets and liabilities of C had fair values equal to their carrying values except for some equipment which had a fair value $100,000 greater than its carrying value. The estimated remaining useful life of the equipment was 10 years. B's 40% share ownership gives the company significant influence over the operations of C.

For the year ended December 31, 20X2, the income statements of the two companies were as follows (B has not recorded any investment income for the year 20X2):

B Ltd. and C Inc.
Income Statements
Year ended December 31, 20X2

	B Ltd.	**C Inc.**
Sales	$980,000	$560,000
Cost of goods sold	$520,000	$310,000
Other expenses	210,000	100,000
Income taxes	100,000	60,000
Total expenses and taxes	$830,000	$470,000
Net income	$150,000	$90,000

During the year ended December 31, 20X2, C sold merchandise to B (upstream) for $140,000. This merchandise had cost $70,000. One half of the merchandise, with an unrealized profit of $35,000, remains in the inventories of B on December 31, 20X2.

The required calculation of B's investment income under the equity method is as follows:

C's net income	$90,000
Unrealized profits in B's inventories	(35,000)
Fair value amortization of equipment ($100,000 ÷ 10)	(10,000)
C's realized income	$45,000
B's ownership percentage	40%
Investment income	$18,000

Using this result, B's income statement is prepared as follows:

B Ltd. Income Statement Year ended December 31, 20X2

Sales	$980,000
Cost of goods sold	520,000
Gross margin	$460,000
Investment income	18,000
Other expenses	210,000
Income taxes	100,000
Total expenses and taxes	$310,000
Net income	$168,000

Note: B's income statement is unchanged except for the inclusion of investment income representing its share of C's results. This illustrates the point that intercompany sales do not influence the equity method results except to the extent that some of the resulting profits are unrealized.

Note: The unrealized profit also has tax consequences if the future income tax method is selected as a policy choice. There are no tax consequences if the taxes payable method is used. These consequences have not been shown here to keep the complexity to a minimum.

APPENDIX E

Accounting for Investments—Points to Remember

Point to Remember	Relevant Reference
Obtain an understanding of the various types of investments and interests in other entities.	
READ the relevant standard: • Section 3856, *Financial Instruments* • Section 3051, *Investments* • Section 3056, *Interests in Joint Arrangements* • Section 1591, *Subsidiaries*	
Document the nature of all investments/interests and the accounting policies selected, when appropriate.	
Develop the note disclosure for significant accounting policies.	1505.03
Prepare the data for the appropriate presentation and disclosure matters **Income Statement** Ensure the income from investments is presented separately on the face of the income statement, separating income from: **(i) non-consolidated subsidiaries and joint arrangements accounted for using the cost or equity method, showing separately:** — income from investments measured using the equity method — income from all other investments in non-consolidated subsidiaries and in joint arrangements accounted for using the cost method **(ii) all other investments, showing separately:** — income from investments measured using the cost method — income from investments measured using the equity method — income from investments measured at fair value.	1520.03 (b)

Point to Remember	Relevant Reference
Balance Sheet	
Separate current investments from long-term investments	1510.03-.05
Separately present the following:	
• Investments in non-consolidated subsidiaries and joint arrangements accounted for using the cost or equity method, showing separately: (i) investments measured using the cost method (ii) investments measured using the equity method (iii) investments measured at fair value	1521.04 (g)
• All other investments showing separately: (i) investments measured using the cost method (ii) investments measured using the equity method (iii) investments measured at fair value.	1521.04 (h)
Cash Flow Statement	1540.36-.37
Ensure the cash flow statement presents the following:	
• Investments accounted for using the equity method: — When the indirect method is used, the equity “pickup” is a non-cash item in the cash flow from operations. — When an investment in an enterprise is accounted for using the equity method, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee (e.g., to dividends and advances).	
• When an enterprise has an interest in a JA and accounts for that interest in accordance with paragraphs 3056.17-.18 (i.e., reporting its share of assets, liabilities, revenue and expenses), the enterprise includes in its consolidated cash flow statement its share of the joint arrangement’s cash flows.	
Non-cash transactions and contributions should be disclosed in a way to provide relevant information about these transactions.	1540.48

NOTE: This is not an exhaustive list of reminders for all entities and types of investments, but it will assist in the identification of investments to assess which Sections may be applicable.

Document all conclusions. It is always important to document the analysis and reference sources to support the conclusion reached when exercising professional judgment.

APPENDIX F

Effective Dates and Additional Resources

There have been numerous changes in the standards related to the accounting for investments. This appendix provides a summary of the amendments and effective dates, as well as additional resources with guidance on each of the following areas:

1. Section 3051, *Investments*
2. Section 1591, *Subsidiaries*
3. Section 3056, *Interests in Joint Arrangements*

1. Section 3051, *Investments*

The following timeline provides a continuum of the revisions to Section 3051:

Initial Standard	December 2016 Revisions	June 2019 Revisions*	November 2019 Revisions
Section 3051 is effective for fiscal years beginning on or after January 1, 2011.	Amended to: • Add guidance on how to apply the cost method; • Add two indicators of impairment relating to the acquisition of an additional interest, sale of a portion of an interest or dilution of an investor's interest in an investee Significant consequential amendments to Section 1500, *First-Time Adoption* to permit a first-time adopter to apply the transitional provisions in amended Section 3051. These amendments were effective for fiscal years beginning on or after January 1, 2018. The amendments were to paragraph 3051.02 and new paragraphs 3051.04(d), 3051.07A and 3051.24(e)-(f), were added.	Amended to clarify that the guidance on how to apply the cost method also applies to JCEs. Significant consequential amendments to Section 1500, *First-Time Adoption* to permit a first-time adopter to apply the transitional provisions in amended Section 3051. These amendments were effective for fiscal years beginning on or after **January 1, 2021**, with early application permitted. Prospective application of the amendments is permitted. Amendments were to paragraph 3051.07A. *Revision issued in August 2020 due to COVID-19; originally effective January 1, 2020.	When Section 3041, *Agriculture* was issued, paragraph 3051.03(d) was added which states that Section 3051 does not apply to biological assets within the scope of Section 3041. An enterprise will apply exclusion, if and when, it applies Section 3041.

Additional Resources:

Guide to Accounting Standards for Private Enterprises (GASPE)

ASPE Alert: Amendments to Investments and Income Taxes

2. Section 1591, *Subsidiaries*

The following timeline provides a continuum of the revisions to Section 1591:

Initial Standard	December 2016 Revisions	December 2018 Revisions*
Section 1591 is effective for fiscal years beginning on or after January 1, 2016.	Amended to: • Set out the underlying principle that an interest in a subsidiary that is subsequently accounted for using the cost method is initially measured on a basis that is similar to other business combinations • Add guidance on how to apply the cost method in accordance with that underlying principle, except that an enterprise does not recognize bargain purchase gains and measures acquisitions of additional interests at cost • Add guidance on the subsequent measurement of an interest in a subsidiary • Add disclosure requirements that apply when an enterprise chooses to account for its subsidiaries by applying the cost or equity method and, therefore, prepares non-consolidated financial statements New paragraphs 1591.23A and 1591.41A were added, and amendments were made to paragraph 1591.42. These amendments were effective for fiscal years beginning on or after January 1, 2017. Further amendments were made to clarify that: • The transitional provisions in paragraphs 1591.42-.47 may not be applied when an enterprise changes its accounting policy choice to consolidate its subsidiaries at any time in the future and that this relief is only available to enterprises transitioning to Section 1591 for the first time • An enterprise preparing non-consolidated financial statements is not required to assess whether contractual arrangements give rise to control. These amendments were effective for fiscal years beginning on or after January 1, 2017. Amendments to paragraphs 1591.24-.26 and 1591.27 and new paragraphs 1591.26A-.26B and 1591.38A-.38F were effective for fiscal years beginning on or after January 1, 2018.	Amended to include guidance on substantive rights to evaluate its effect on control assessments. Amendments were to paragraphs 1591.14 and 1591.30 and new paragraphs 1591.14A-.14D were added. These amendments were effective for fiscal years beginning on or after **January 1, 2021***. Earlier application is permitted. *Revision issued in August 2020 due to COVID-19; originally effective January 1, 2020. Amendments to Section 3856, *Financial Instruments* in December 2018 resulted in consequential amendments to Section 1591.

3. Section 3056, *Interests in Joint Arrangements*

The following timeline provides a continuum of the revisions to Section 3056:

Initial Standard	December 2016 Revisions	December 2018 Revisions*
Section 3056 is effective for fiscal years beginning on or after January 1, 2016	New paragraph 3056.43B, was added to clarify that the transitional provisions in paragraphs 3056.44-.49 may not be applied when an enterprise changes its accounting policy choice to consolidate its subsidiaries at any time in the future and that this relief is only available to enterprises transitioning to Section 3056 for the first time. This clarification was effective for fiscal years beginning on or after January 1, 2017.	Amendments to paragraph 3056.22 to clarify that when a new investor and existing investors are related parties prior to the contribution to a joint arrangement of non-monetary assets, other than product or property held for sale in the normal course of operations to facilitate sales to customers, the contribution is accounted for as a non-monetary transaction in accordance with Section 3840, *Non-Monetary Transactions* or Section 3856, *Financial Instruments*. These amendments were effective for fiscal years beginning on or after **January 1, 2021***, with early application permitted. *Revision issued in August 2020 due to COVID-19; originally effective January 1, 2020.