

Investments in Associates (Ind AS 28)

Agenda

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Scope & Exemptions

Scope

- Applies to all entities that are investors with joint control of, or significant influence over, an investee.
- Investments in associates held by or held indirectly through:
 - Venture capital organisations, or
 - Mutual funds, unit trusts and similar entities including investment-linked insurance funds

May be elected to be measured at FVTPL in accordance with Ind AS 109. [Ind AS 28.18]

Ind AS 28 Scope – Exemptions

- If below conditions apply then entity need not apply the equity method to its associates or joint ventures:
 - The entity is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners and those not entitled to vote do not object to, the entity not applying the equity method;
 - The entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
 - The entity did not file, nor is it in the process of filing, its financial statements with a securities commission for the purpose of issuing any class of instruments in a public market;
 - If the ultimate or any intermediate parent of the investor entity produces consolidated financial statements available for public use that comply with Ind ASs. [Ind AS 28.17]

Ind AS 28 Scope – Exemptions (continued)

- An entity also need not apply equity method to associates or joint ventures if it is a parent that is exempt from preparing consolidated financial statements by the scope exception in paragraph 4(a) of Ind AS 110.

Key Terms

Ind AS 28 Key Terms

Associate	An entity over which the investor has significant influence.
Consolidated Financial Statements	The financial statements of a group in which assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic activity.
Equity Method	A method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

Ind AS 28 Key Terms (continued)

Joint Control	The contractually agreed sharing of control over an arrangement, which exists only when the decisions about the relevant activities require the unanimous consent of the parties sharing control.
Joint Venture	Joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
Significant Influence	The power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.
Joint Venturer	Party to a joint venture that has joint control of that joint venture.

Significant Influence

Significant Influence

- If an investor has significant influence over an investee, the investor accounts for its investment in the investee using the equity method.
- If an investor holds, directly or indirectly, 20% or more of the voting power of an investee, it is presumed that an investor has significant influence, unless it can be clearly demonstrated that this is not the case.
- If an investor holds, directly or indirectly, less than 20% of the voting power of an investee, it is presumed that an investor does not have significant influence, unless such influence can be clearly demonstrated.
- A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

Evidence of Significant Influence

Significant influence is usually evidenced in one or more of the following ways (Ind AS 28 paragraph 6 indicators):

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

Significant Influence – Potential Voting Rights

- Instruments that have the potential, if exercised or converted, to give an entity voting power or reduce another party's voting power over the financial and operating policies of another entity.

Example – share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments.

- In assessing significant influence, consideration is given to potential voting rights that are currently exercisable or convertible.
- In assessing whether potential voting rights contribute to significant influence, the entity should examine all facts and circumstances that affect potential voting rights (including terms of exercise) **except**:
 - The intention of management
 - Financial ability to exercise or convert those potential rights.

Loss of Significant Influence

- Occurs when an entity loses the power to participate in the financial and operating policy decisions of the investee
- Can occur with or without a change in absolute or relative ownership levels.
- It could occur, for example, when:
 - An associate becomes subject to the control of a government, court, administrator or regulator; or
 - As a result of a contractual agreement.

Significant Influence – Example – Facts

Background:

Entity A owns 15% of the ordinary shares that carry voting rights in Entity B.

Entity B is governed through its ordinary shares that carry voting rights and is not subject to joint control.

Entity A also owns call options that are exercisable at any time at the fair value of the underlying shares and if exercised would give it an additional 10% of the ordinary shares that carry voting rights in Entity B. The call options do not lack economic substance.

Assume that no other arrangements or instruments exist that would enable Entity A or any other investor to acquire additional ordinary shares in Entity B.

Question

Based on the facts provided, does Entity A have significant influence over Entity B?

Significant Influence – Example

Answer:

Yes. It is presumed that an investor has the ability to exercise significant influence if it holds, directly or indirectly, 20% or more of the voting power of an investee. The combination of Entity A's current ownership interest in Entity B's ordinary shares that carrying voting rights and its potential voting rights (i.e. call options to acquire an additional 10% of Entity B's ordinary shares) give Entity A the ability to exercise significant influence

Significant Influence – Example

Background:

If an entity holds, directly or indirectly (e.g. through subsidiaries), less than 20 per cent of the voting power of an investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated.

Question

- What are the indicators of the existence of an entity's ability to exercise significant influence over a less than 20 per cent-owned investee?

Answer:

Decisions regarding the appropriateness of applying the equity method of accounting for a less than 20 per cent-owned investee require careful evaluation of voting rights and their impact on the entity's ability to exercise significant influence. The existence of the following circumstances may indicate that an entity is in a position to exercise significant influence over a less than 20 per cent-owned investee:

- representation on the board of directors or equivalent governing body of the investee;
- participation in policy-making processes, including participation in decisions about dividends or other distributions;
- material transactions between the entity and the investee;
- interchange of managerial personnel; or
- provision of essential technical information.

Significant Influence – Example

Background:

If an entity holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case.

Question

- **What circumstances might indicate that an entity holding 20 per cent or more of the voting power of an investee lacks the ability to exercise significant influence?**

Answer:

The following circumstances may call into question whether an entity has the ability to exercise significant influence. The list is not exhaustive, and all facts and circumstances need to be assessed carefully.

- The chairman of the investee owns a large, but not necessarily controlling, block of the investee's outstanding shares; the combination of the chairman's substantial shareholding and his position within the investee may preclude the entity from having an ability to influence the investee.
- Adverse political and economic conditions exist in the foreign country where the investee is located.
- Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the entity's ability to exercise significant influence.
- The entity and the investee sign an agreement under which the entity surrenders significant rights as shareholder.
- Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the entity.
- Litigation against an investee, particularly when the investee is in bankruptcy, is to be settled by the investee issuing shares to the settling parties and it is probable the new shares, when issued, will reduce the entity's ownership percentage.
- Severe long-term restrictions impair the entity's ability to repatriate funds.

Significant Influence – Example

Background:

Company A has two subsidiaries, Company B and Company C. Company B has a 15 per cent ownership interest in Company C. The group structure is as follows.

Company A has appointed an executive of Company B as a director to the board of Company C. Because of the number of directors on the board, this director is able to influence significantly Company C's board. Company A has the right to remove the executive from the board at any time. Company B has also been directed by Company A to manage Company C in a way that maximises the return from both Company B and Company C, which are located in the same jurisdiction. Company A can amend this directive at any time.

Note that Company B has not chosen to apply the equity method exemption in IAS 28(2011).17. Also, Company A and Company B have no further agreements regarding Company C's financial and operating policy decisions.

Question:

Does Company B have significant influence over Company C such that Company C is an associate of Company B?

Significant Influence – Example

Answer:

No. Ind AS 28(2011).5 indicates that "[a] substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence". In this scenario, however, Company B does not have significant influence over Company C. Although Company B can participate in policy-making decisions, Company A can remove Company B's executive from Company C's board at any time. Therefore, Company B's apparent position of significant influence over Company C can be removed by Company A and Company B does not have the power to exercise significant influence over Company C

Equity Method and its application

Equity method

- Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition.
- The investor's share of the investee's profit or loss is recognised in the investor's profit or loss.
- Distributions received from an investee reduce the carrying amount of the investment.
- Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income.
- The investor's share of those changes is recognised in the investor's other comprehensive income.

Equity method (continued)

- When potential voting rights exist, the interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights, unless its in substance existence of ownership (see below).
- When an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest, the method is applied by taking into account as if the those potential voting rights were exercised that currently give the entity access to the returns.

When instruments containing potential voting rights create an in substance ownership interest in an associate or a joint venture, they are accounted as per the equity method. In all other cases, these instruments containing potential voting rights in an associate or a joint venture are accounted under Ind AS 109.

Equity Method Example

Question:

Are there circumstances in which an investment in preferred shares should be accounted for using the equity method?

Answer:

Yes. When an investment in preferred shares is determined to be substantively the same as an investment in ordinary shares, the investment may give the investor significant influence, in which case the investment should be accounted for using the equity method. Factors that either individually or collectively may indicate that a preferred share investment is substantively the same as an ordinary share investment include:

- The investee has little or no significant ordinary shares or other equity, on a fair value basis, that is subordinate to the preferred shares;
- The investor, regardless of ownership percentage, has demonstrated the power to exercise significant influence over the investee's operating and financial decisions. The power to participate actively is an important factor in determining whether an equity interest exists by virtue of preferred shareholdings;
- the investee's preferred shares have essentially the same rights and characteristics as the investee's ordinary shares as regards voting rights, board representation, and participation in, or rate of return approximating, the ordinary share dividend; and
- the preferred shares have a conversion feature (with significant value in relation to the total value of the shares) to convert the preferred shares to ordinary shares.

Reporting period differences

- The most recent available financial statements of the associate or joint venture are used in applying the equity method.
- When the end of the reporting periods are different, the associate or joint venture prepares financial statements as of the same date to facilitate equity accounting unless it is impracticable to do so.
- When impracticable, the difference in reporting period-ends shall in any case not exceed 3 months and adjustments are made for the effects of significant transactions or events that occur between the two reporting period-ends.
- Length of the reporting periods and the difference between reporting periods shall be consistent.

Uniform accounting policies

- Unless impracticable to do so in case of an associate, the financial statements of the investor shall be prepared using uniform accounting policies i.e. if the associate or joint venture uses different accounting policies for like transactions and events in similar circumstances, adjustments are made for purposes of equity accounting.

Recognition of Losses in applying equity accounting

- Interest in associate or joint venture is carrying amount of investment together with any long-term interests that, in substance, form part of the investor's net investment in the associate or joint venture.
- If share of losses exceed interest in associate or joint venture (as described above), investor should **discontinue** recognising its share of further losses *unless a legal or constructive obligation exists*.

Determining whether there is impairment

- Apply Ind AS 109 to interest in associate or joint venture that is within scope of Ind AS 109 and does not form part of net investment.
- For the other interest i.e. net investment after applying the equity method, assess whether there is objective evidence that the net investment in associate or joint venture is impaired.

How to determine if net investment in associate or joint venture is impaired?

- The net investment is impaired only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the net investment (a 'loss event') and that loss event(s) has an impact on the estimated future cash flows from the net investment that can be reliably estimated.
- Not possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment.

How to determine if net investment in associate or joint venture is impaired? (continued)

Objective evidence that the net investment is impaired **includes** observable data that comes to the attention of the entity about the following loss events:

- significant financial difficulty;
- a breach of contract, such as a default or delinquency in payments;
- the entity, for economic or legal reasons relating to its associate's or joint venture's financial difficulty, granting it a concession that the entity would not otherwise consider;
- it becoming probable that the associate or joint venture will enter bankruptcy or other financial re-organisation; or
- the disappearance of an active market for the net investment because of financial difficulties.

How to determine if net investment in associate or joint venture is impaired? (continued)

- Disappearance of an active market i.e. the associate's or joint venture's equity or other financial instruments no longer publicly traded is not evidence of impairment.
- A downgrading in credit rating or decline in the fair value is not in itself evidence of impairment but may be evidence when considered with other available information.
- Objective evidence also includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment and indicate that the cost of the investment in the equity instrument may not be recovered.
- A significant or prolonged decline in the fair value of investment below its cost is also objective evidence of impairment.

Impairment testing

- Goodwill not tested separately for impairment
- Instead, if there is objective evidence of impairment, the entire investment is tested in accordance with Ind AS 36 as a single asset.
- The testing is done by comparing the recoverable amount with carrying amount.
- The recoverable amount is higher of value in use and fair value less costs to sell.
- The impairment loss on an associate or joint venture is not allocated to any asset such as goodwill or other asset forming part of net investment.
- Any reversal of impairment is recognised in accordance with Ind AS 36 to the extent that the recoverable amount subsequently increases.
- The recoverable amount is assessed for each associate or joint venture unless they do not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.

Example on Impairment

Question:

In addition to the guidance in Ind AS 36 Impairment of Assets, what are other examples of indicators that an equity-method investment is impaired?

Answer:

The following factors provide additional evidence as to whether an equity-method investment might be impaired:

- the financial condition and near-term prospects of the equity-method investee, including any specific events that may influence its operations (such as changes in technology or the discontinuance of a business segment that may impair its earnings potential);
- the financial performance and projections of the equity-method investee;
- trends in the general market;
- the capital strength of the equity-method investee;
- the dividend payment record of the equity-method investee;
- known liquidity crisis;
- bankruptcy proceedings; and
- going concern commentary in the auditor's report on the investee's most recent financial statements.

IAS 39 Financial Instruments: Recognition and Measurement requires that financial assets be assessed at the end of each reporting period to determine whether there is any objective evidence that they are impaired.

Example on Impairment

Question:

When an impairment loss has previously been recognized in respect of the carrying amount of an investment accounted for using the equity method that included goodwill, does IAS 28 permit the impairment loss to be reversed to the extent that it related to the goodwill?

If the equity carrying amount of an investee included CU100 goodwill, and an impairment loss of CU150 was recognized, the goodwill effectively has been eliminated. If the recoverable amount subsequently increases to its original value, is it appropriate for the entire impairment of CU150 to be reversed, or is the reversal restricted to CU50?

Example on Impairment contd...

Answer:

Generally, in appropriate circumstances, impairment losses recognized in respect of investments accounted for using the equity method can be reversed. However, the question arises as to whether this is permitted in respect of goodwill included in the carrying amount of such investments, given the general prohibition on reversing impairment losses relating to goodwill (see IAS 36 Impairment of Assets).

IAS 28(2011).42 states that because goodwill included in the carrying amount of an equity-method investee is not separately recognized, it is not tested for impairment separately under the principles of IAS 36. Instead, the entire carrying amount of the investment is tested under IAS 36 for impairment by comparing its recoverable amount with its carrying amount, whenever application of the requirements in IAS 39 Financial Instruments: Recognition and Measurement indicates that the investment may be impaired. Although not specifically addressed in IAS 28, the treatment of reversals of impairment losses should mirror the requirements of IAS 28(2011).42. The investment, therefore, is treated as a whole, and the goodwill is not treated separately; thus, there is no prohibition against restoring the carrying amount of the investment to its pre-impairment value, in appropriate circumstances.

Therefore, in the example above, the entire impairment loss of CU150 could be reversed if the general conditions for the reversal of the impairment of an equity-method investment are met.

Determining the value in use of the net investment

In determining the value in use of the net investment, an entity estimates:

- (a) its share of the present value of the estimated future cash flows expected to be generated by the associate or joint venture, including the cash flows from the operations of the associate or joint venture and the proceeds from the ultimate disposal of the investment; or
- (b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Using appropriate assumptions, both methods give the same result.

Discontinuing the use of Equity Method

Discontinuing the use of Equity Method

- Discontinue from the date when investment ceases to be an associate or a joint venture as follows:
 - a) If it becomes a subsidiary, account in accordance with Ind AS 103, and Ind AS 110.
 - b) If the retained interest in the former associate or joint venture is a financial asset, measure the retained interest at fair value. This will be fair value on initial recognition of a financial asset in accordance with Ind AS 109. Recognise in profit or loss any difference between:
 - i. the fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and
 - ii. the carrying amount of the investment at the date the equity method was discontinued.

Discontinuing the use of Equity Method (contd.)

- c) Account for all amounts previously recognised in OCI in relation to that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.
- If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest.

Case Study

Case Study - Facts

A and B form a joint venture i.e. C by investing Rs.1 million each for a 50% ownership interest.

A and B account for their respective interests in C pursuant to the equity method.

C subsequently incurs a loss of Rs.2.4 million.

C has available cash and distributes Rs.100,000 each to both A and B.

The distribution is not refundable and A is not liable for obligations of C or otherwise committed to provide financial support to C.

Case Study – Questions/Solutions

Question 1 - should A continue to apply the equity method and recognise losses in excess of its equity method investment in C?

Solution 1 - A should suspend its application of the equity method to its investment in C and not record any further losses

Case Study – Questions/Solutions

Question 2 - how should A account for the Rs.100,000 distribution received from C?

Solution 2 - A should record the Rs.100,000 received as income.

Case Study – Questions/Solutions

Question 3 - At what point, if ever, should A resume application of the equity method?

Solution 3 - A would resume applying the equity method when C becomes profitable such that A's share of C's earnings exceeds the distributions and share of unrecognised losses attributable to A.

DISCLOSURE REQUIREMENTS

The following disclosures shall be made in the financial statements:

- The fair value of the investments in associates for which there are published price quotations
- Summarized financial information of associates, including the aggregated amounts of assets, liabilities, revenues and profit or loss
- The reasons why the presumption that an investor does not have significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, less than 20 percent of the voting or potential voting power of the investee but concludes that it has significant influence.
- The reason why the presumption that the significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, 20 percent or more of the voting or potential voting power of the investee but concludes that it does not have significant influence.
- The end of the reporting period of the financial statements of an associate, when such financial statements are used in applying the equity method and are as of a date or for a period that is different from that of the investor and the reason for using a different date or different period

DISCLOSURE REQUIREMENTS

- The nature and extent of any significant restrictions (eg: resulting from borrowing arrangements or regulatory requirements) on the ability of associates to transfer funds to the investor in the form of cash dividends, or repayment of loans or advances:
- The unrecognized share of losses of an associate , both for the period and cumulatively, if an investor has discontinued recognition of its share of losses of an associate.
- The fact that an associate is not accounted for using the equity method in accordance with paragraph 13; and
- summarized financial information of associates, either individually or in groups , that are not accounted for using the equity method, including the amounts of total assets, total liabilities, revenue and profit or loss.

