IAS 28 Investment in Associates - A Closer Look

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IAS 28,
Investments in Associates
- A Closer Look

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International Accounting Standard (IAS) 28, *Investments in Associates,* prescribes the circumstances in which investors must use the equity method of accounting for investments in associates. In July 1986, the International Accounting Standards Committee (IASC) issued the Exposure Draft E28, *Accounting for Investments in Associates and Joint Ventures*. In April 1989, the IASC issued IAS 28, *Accounting for Investments in Associates,* effective from January 1, 1990. IAS 28 was reformatted in 1994, and amended in 1998, 1999 and 2000. In December 1998, IAS 28 was amended by IAS 39, *Financial Instruments: Recognition and Measurement,* effective from January 1, 2001. In April 2001, the International Accounting Standards Board (IASB) resolved that all Standards and Interpretation issued under previous Constitutions continued to be applicable unless and until they were amended or withdrawn. On December 18, 2003, the IASB issued a revised IAS 28 with a new title – *Investments in Associates*, effective from January 1, 2005. On January 10, 2008, the IASB issued some significant revisions of IAS 28 as a result of the Business Combinations Phase II Project relating to loss of significant influence. On May 22, 2008, IAS 28 was amended for *Annual Improvements to IFRSs 2007* about impairment testing. The effective date of May 2008 amendments to IAS 28 was fixed as January 1, 2009. The effective date of January 2008 amendments to IAS 28 was fixed as July 1, 2009.

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Objective

The objective of IAS 28 is to prescribe the accounting treatment investors shall apply to their investments in associates and the required disclosures. Effectively, it describes when the relationship between an investor and an investment reflects an investor / associate relationship.

Scope and Application

IAS 28 applies in accounting for all investments in which an investor has significant influence. However, it does not apply to investments in associates held by:
(a) venture capital organisations, or
(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39. Such investments shall be measured at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change.

Key Definitions

Paragraph 2 of IAS 28 provides definitions for the following key terms (among others):
Associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.
Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.
Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
Equity method is a method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the associate (investee). The profit or loss of the investor includes the investor's share of the profit or loss of the investee.
Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).
Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.
Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.
Subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

Identification of Associates

Significant influence is evidenced by factors such as where an investor:

- holds, directly or indirectly (e.g. through subsidiaries but excluding voting power held by associates), 20 per cent or more of the voting power of the investee
- has representation on Board of Directors or equivalent governing body of the investee
- participates in policy-making processes of the investee
- engages in material transactions with the investee
- interchange of managerial personnel or
- provision of essential technical information to the investee

An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or reduce another party's voting power over the financial and operating policies of another entity (i.e. potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intention of management and the financial ability to exercise or convert.

An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence 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. It could also occur as a result of a contractual agreement.

Prescribed Accounting Treatment

IAS 28 requires that associates are accounted for using equity method of accounting. Under the equity method of accounting, an equity investment is initially recorded at cost and is subsequently adjusted to reflect the investor's share of the net profit or loss of the associate. Subsequently, the carrying amount of the investment 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 profit or loss of the investee is recognised in the investor's profit or loss.

The following transactions will have an impact on the carrying amount of the investment:
• 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 equity that have not been recognised in the investee's profit or loss

When potential voting rights exist, the investor's share of profit or loss of the investee and of changes in the investee's equity is determined on the basis of present ownership interests and does not reflect the possible exercise or conversion of potential voting rights.

In its consolidated financial statements, an investor should use the equity method of accounting for investments in associates unless:

• the investment is classified as held for sale in accordance with IFRS 5, *Non-current assets held for sale and discontinued operations*

• in accordance with IAS 27, the exception allowing a parent with an interest in an associate not to present consolidated financial statements applies

• all of the following apply:
— the investor is a wholly owned subsidiary or is a partially owned subsidiary of another entity and its other owners (including those not otherwise entitled to vote), have been informed about, and do not object to, the investor not applying the equity accounting
— the investor's debt and equity instruments are not traded in a public market
— the investor did not file nor is it in the process of filing its financial reports with a securities commission or regulatory organisation, for the purpose of issuing any instrument in a public market
— the ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use and in accordance with IFRSs

When an investment in an associate previously classified as held for sale no longer meets the criteria to be so classified, it shall be accounted for using the equity method as from the date of its classification as held for sale. Financial statements for the periods since classification as held for sale shall be amended accordingly.

The recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate because the distributions received may bear little relation to the performance of the associate. Because the investor has significant influence over the associate, the investor has an interest in the associate's performance and, as a result, the return on its investment. The investor accounts for this interest by extending the scope of its financial statements to include its share of profits or losses of such an associate. As a result, application of the

equity method provides more informative reporting of the net assets and profit or loss of the investor.
The carrying amount of the investment at the date that it ceases to be an associate shall be regarded as its cost on initial measurement as a financial asset in accordance with IAS 39. The investor shall discontinue the use of the equity method from the date that it ceases to have significant influence.

An investor shall discontinue the use of the equity method from the date when it ceases to have significant influence over an associate and shall account for the investment in accordance with IAS 39 from that date, provided the associate does not become a subsidiary or a joint venture as defined in IAS 31, *Interests in Joint Ventures*. On the loss of significant influence, the investor shall measure at fair value any investment the investor retains in the former associate. The investor shall recognise in profit or loss any difference between:
(a) the fair value of any retained investment and any proceeds from disposing of the part interest in the associate; and
(b) the carrying amount of the investment at the date when significant influence is lost.

When an investment ceases to be an associate and is accounted for in accordance with IAS 39, the fair value of the investment at the date when it ceases to be an associate shall be regarded as its fair value on initial recognition as a financial asset in accordance with IAS 39.

If an investor loses significant influence over an associate, the investor shall account for all amounts recognised in other comprehensive income in relation to that associate on the same basis as would be required if the associate had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognised in other comprehensive income by an associate would be reclassified to profit or loss on the disposal of the related assets or liabilities, the investor reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses significant influence over the associate. For example, if an associate has available-for-sale financial assets and the investor loses significant influence over the associate, the investor shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to those assets. If an investor's ownership interest in an associate is reduced, but the investment continues to be an associate, the investor shall reclassify to profit or loss only a proportionate amount of the gain or loss previously recognised in other comprehensive income.

An investment in an associate is accounted for using the equity method from the date on which it becomes an associate. On acquisition of the investment any difference between the cost of the investment and the investor's share of the net fair value of the associate's identifiable assets and liabilities is accounted for as follows:
(a) goodwill relating to an associate is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.
(b) any excess of the investor's share of the net fair value of the associate's identifiable assets and liabilities over the cost of the investment is included as income in the

determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.
Appropriate adjustments to the investor's share of the associate's profits or losses after acquisition are also made to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the investor's share of the associate's profits or losses after acquisition are made for impairment losses recognised by the associate, such as for goodwill or property, plant and equipment.

Dissimilar Reporting Dates

The most recent available financial statements of the associate are used in applying the equity method. When the end of the reporting period of the investor is different from that of the associate, the associate prepares, for the use of the investor, financial statements as of the same date as the financial statements of the investor unless it is impracticable to do so. If restatement is impracticable, IAS 28 requires that adjustments shall be made for the effects of any significant events or transactions that occur between the date and the date of the investor's financial statements. In any case, the difference between the reporting date of the associate and that of the investor shall be no more than three months.

Dissimilar Accounting Policies

IAS 28 states that the investor's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances. Therefore, if an associate uses accounting policies that differ from those of the investor, adjustments are required for consistency.

Impairment losses

After application of the equity method, including recognising the associate's losses in accordance with paragraph 29, the investor applies the requirements of IAS 39 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.
The investor also applies the requirements of IAS 39 to determine whether any additional impairment loss is recognised with respect to the investor's interest in the associate that does not constitute part of the net investment and the amount of that impairment loss.
Because goodwill that forms of the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in IAS 36, *Impairment of Assets*. Instead, the entire carrying amount of the investment is tested for impairment in accordance with IAS 36 as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount, whenever application of the requirements in IAS 39 indicates that the investment may be impaired. An impairment loss recognized in those circumstances is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in the associate.

Accordingly, any reversal of that impairment loss is recognised in accordance with IAS 36 to the extent that the recoverable amount of the investment subsequently increases. In determining the value in use of the investment, an entity estimates:
(a) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on 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.
Under appropriate assumptions, both methods give the same result.
The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.

Separate Financial Statements of the Investor

Equity accounting is required in the separate financial statements of the investor even if consolidated accounts are not required, for example, because the investor has no subsidiaries. But equity accounting is not required where the investor would be exempt from preparing consolidated financial statements under IAS 27. In that circumstance, instead of equity accounting, the parent would account for the investment either (a) at cost or (b) in accordance with IAS 39.

Prescribed Disclosures

Required disclosures include:
• the fair value of investments in associates if published price quotations are available
• a summary of the associates' financial information including the aggregated amounts of assets, liabilities, revenues and profit or loss
• the explanations when investments of less than 20% are accounted for by the equity method or when investments of more than 20% are not accounted for by the equity method
• use of a reporting date of the financial statements of an associate that is different from that of the investor
• the nature and extent of any significant restrictions on the ability of associates to transfer funds to the investor in the form of cash dividends, repayment of loans or advances
• the unrecognised 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
• explanation of any associate is not accounted for using the equity method
• summarised 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, revenues, and profit or loss
• investments in associates which are equity-accounted shall be classified as non-current assets with separate disclosure of the profit or loss of the associates, the carrying amount of the investments and the investor's share of any discontinuing operations

The following disclosures relating to contingent liabilities are also required:

• investor's share of changes recognised directly in the associate's equity shall be directly recognised in the investor's equity and shall be disclosed in the statement of changes in equity

• in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, investor shall disclose its share of contingent liabilities of an associate incurred jointly and those that arise because the investor is severally liable for all or part of the associate's liabilities

Venture capital organisations, mutual funds, and other similar entities must provide disclosures about nature and extent of any significant restrictions on transfer of funds by associates.

Presentation

- Equity method investments must be classified as non-current assets.
- The investor's share of the profit or loss of equity method investments, and the carrying amount of those investments, must be separately disclosed.
- The investor's share of any discontinuing operations of such associates is also separately disclosed.

The investor's share of changes recognised directly in the associate's other comprehensive income are also recognised in other comprehensive income by the investor, with disclosure in the statement of changes in equity as required by IAS 1, *Presentation of Financial Statements*.

Interpretations

The Standards Interpretations Committee (SIC) of the IASC and the International Financial Reporting Interpretations Committee (IFRIC) of the IASB has issued the following four Interpretations relating to IAS 28:

• SIC 3, *Elimination of Unrealised Profits and Losses on Transactions with Associates* (issued in December 1997 and superseded by 2003 revision of IAS 28)

• SIC 20, *Equity Accounting Method - Recognition of Losses* (issued in July 2000 and superseded by 2003 revision of IAS 28)

• SIC 33, *Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interest* (issued in December 2001 and superseded by 2003 revision of IAS 28)

- IFRIC 5, *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* (issued on December 16, 2004, effective from January 1, 2006)

IFRIC 5: Some entities have obligations to decommission assets or to perform environmental restoration or rehabilitation. Some such entities contribute to a fund established to reimburse the decommissioning, restoration or rehabilitation costs when they are incurred. The fund may be set up to meet the decommissioning costs of a single contributor or for many contributors.

If an entity recognises a decommissioning obligation under IFRSs and contributes to a fund to segregate assets to pay for the obligation, it should apply IAS 27, SIC 12, *Consolidation – Special Purpose Entities*, IAS 28, and IAS 31, to determine whether decommissioning funds should be consolidated, proportionately consolidated or accounted for under the equity method.

When a fund is not consolidated, proportionately consolidated, or accounted for under the equity method, and that fund does not relieve the contributor of its obligation to pay decommissioning costs, the contributor should recognise:

- its obligation to pay decommissioning costs as a liability, and
- its rights to receive reimbursement from the fund as a reimbursement under IAS 37.

A right to reimbursement should be measured at the lower of (i) the amount of the decommissioning obligation recognised and (ii) the contributor's share of the fair value of the net assets of the fund. Changes in the carrying amount of this right (other than contributions to and payments from the funds) should be recognised in profit or loss.

When a contributor has an obligation to make potential additional contributions to the fund, that obligation is a contingent liability within the scope of IAS 37. When it becomes probable that the additional contributions will be made, a provision should be recognised.

Sweep issue on IAS 28: Clarification on the partial use of fair value amendment

In February 2010, the IASB approved an Annual Improvement amendment to IAS 28 to enable a parent entity to measure part of the investment in an associate at fair value in its consolidated financial statements when that part is designated as at fair value through profit or loss in accordance with the scope exclusion in paragraph 1 of IAS 28 (the 'venture capital organisations' exception). This amendment will be issued as a consequential amendment in the forthcoming IFRS on Joint Arrangements.

Comparative Indian Standard

The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 28 is AS 23, *Accounting for Investments in Associates*. AS 23 is based on IAS 28 (revised 2000). The major differences between these two standards are Conceptual Differences: Goodwill/Capital reserve is calculated by computing the difference between the cost to the parent of its investment in the subsidiary and the parent's portion of equity in the subsidiary in AS 23 whereas in IAS 28 fair value approach is followed.

In the IFRS convergence process, the ICAI has issued Exposure Draft (ED) of IFRS-converged Indian Accounting Standards. There is no major difference between the ED of AS 23 and IAS 28 except that where the financial statements of the associate used in applying equity method are prepared as of a different date from that of the investor, IAS 28 requires that this difference should not be more than three months. However the ED of AS 23 provides that this difference should not be more than three months, unless impracticable.

Conclusion

The IASB agreed that significant influence over the investee is not required at the level of the venture capital organisation to measure the investment at fair value through profit or loss at group level. Finally, the proposed amendments are likely to use the phrase 'venture capital organisations or mutual funds, unit trusts and similar entities, including investment-linked insurance funds' (or something similar), until such time as the IASB's forthcoming exposure draft proposing a definition of an 'investment entity' is issued in a final IFRS.

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