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IAS® Standard 28 Investment in Associates and Joint Ventures

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IAS® Standard 28 Investment in Associates and Joint Ventures

SCOPE AND KEY DEFINITIONS

IAS® Standard 28 Investment in Associates and Joint Ventures specifically focuses on the associates and equity method. An associate is defined as an entity over which the investor has significant influence. The concept of associate is closer to the investor-investee relationship rather than the parent-subsidiary relationship.

For the investor to identify an investee as an associate, the investor must have a significant influence on it. In this regard, key definitions of IAS 28 such as significant influence, control, joint control, and joint venture must be explained first. Detailed explanations of these definitions can be seen in figure 1 (IAS 28.3).

Figure 1: Key definitions of IAS 28

Significant influence	the power to participate in the financial and operating policy decisions of an investee but does not have control or joint control over those policies.
Control	when an investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
Joint Control	contractually agreed sharing of control over an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
Joint Venture	a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

The basic criteria for identifying an associate is significant influence. Significant influence does not refer to control or joint control. The main indicator of significant influence is to hold 20% or more (but less than 50%) shares of the investee unless it can be demonstrated that this is not the case. The percentage limits of shares are not the sole indicators for the determination of significant influence. Even if the investor holds less than 20% shares, the existence of one or more of the below situations is also considered as an indicator of significant influence (IAS 28.6):

- Investor's representation in the board of directors,
- Investor's participation in decision-making processes such as dividends,
- Significant amount of transactions between the entity and its investee,
- Interchange of managerial personnel,
- Providing essential technical information.

Despite holding 20% or more shares of the investee, the investor may not have a significant influence on the investee if none of the significant influence indicators exist.

Significant influence disappears when the investor loses its participation power in the associate's operating and financial decisions. Significant influence disappears in case of a change in absolute or relative ownership levels. Suppose that a government, court, administrator, or regulator becomes the controller of an associate. In addition, loss of a significant influence could occur due to a contractual arrangement, (IAS 28.9).

It is crucial to consider potential voting rights in the determination of significant influence. However, only the current voting rights are considered on the recognition, potential voting rights are not considered on the recognition.

EXAMPLE 1

Sky Entity owns 25% shares of ICell Software. The Local Government holds the other 75% of ICell and Sky will not be involved in the day-to-day running of the business and has no means to participate in the operating and financial decision-making processes of the investee. Does Sky have control, joint control, or significant influence over ICell or is ICell just a financial asset for Sky Entity?

SOLUTION 1

ICell is a financial asset of Sky entity because Sky does not have the right to make or participate in all relevant decisions about the financial and operating policy of ICell. Therefore, it does not have control or significant influence over ICell.

EXAMPLE 2

C-day entity owns a 10% share of the Alp Solutions entity. In addition, the C-day entity has four directors in the board, and the board of directors consists of ten members. Based on the agreement, a majority of directors are required to approve the board decisions. Does C-day entity have a significant influence, control, or joint control over Alp Solutions or should Alp Solutions be considered as a financial asset for C-Day entity?

SOLUTION 2

IAS 28 presumes that when considering significant influence entities should have at least 20% share over an investee. However, even when this criterion is not met, special situations such as representation in the board of directors should be considered. In this case, despite C-day has less than 20% share, this entity sits in the board of directors with four members out of a total of ten members. 40% representation on the boards of directors shows that C-day has a significant influence over Alp Solutions.

To determine when companies recognize an investment as an associate or subsidiary and which recognition method they apply, recognition rules of investing types based on IAS/IFRS are presented in Table 1.

Table 1: Recognition Rules of Investing Types

	Subsidiary	**Associate**	**Joint Agreement**
CRITERIA	Control Power	Significant Influence	Joint Control
SHARE	More than %50	Between 20-50%	Equal
RECOGNITION	Consolidation	Equity Method	Depends on the type
OTHER INVESTMENT: Financial Instruments (IFRS 9 / IAS 39)			

RECOGNITION and MEASUREMENT

Once the significant influence is determined, the associates should be recognized by using the equity method. In addition, joint ventures with joint control that are defined in detail on IFRS Standard 11 Joint Arrangements are recognized in the equity method as well. When applying this method, if reporting dates of the investor and associate or joint venture are different, the associate or joint venture prepares financial statements on the investor's reporting date. If it is not possible to do that on the same reporting date, then the most recent financial statement of an associate or joint venture is used. Nevertheless, the difference between reporting dates must not exceed three months. In addition, an associate or joint venture should use the same accounting policies as the investors. If not, then the adjustments need to be made on the associate's or joint venture's financial statements to conform to the investor's accounting policies.

Initial Measurement

Under the equity method, investments in associates or joint ventures are first recognized at acquisition cost. Acquisition cost includes the purchase cost and other costs directly related to purchasing.

For example, an entity purchases 35% of another entity with a total of CU52,500. The carrying value of the net assets of the investee is CU150,000. In this regard, the initial measurement is CU52,500 which is the acquisition cost.

There are exemptions to the application of the equity method such as when an entity is a parent and it is exempt from preparing consolidated financial statements and it fits all the below situations, the investor is not obliged to apply the equity method (IAS 28.17):

- The entity 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 entity's 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 or other regulatory organization, to issue any class of instruments in a public market.

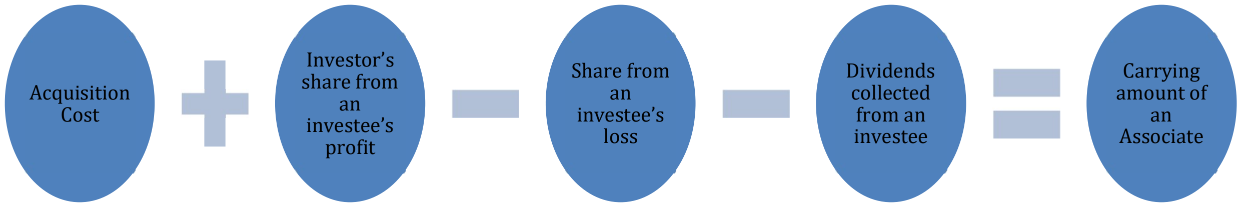
- The ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with IFRSs.

Measurement after Recognition

After the date of acquisition, the carrying amount of the investment is increased or decreased based on the shares of the investee's equity. Distributions such as dividends of an investee decrease the carrying amount. The carrying amount of the investment may need to be adjusted based on the investor's share of the changes in the associate's other comprehensive income. These kinds of changes might have occurred due to the revaluation of properties or foreign currency conversion adjustments. Investors' share from these changes is recognized in investors' comprehensive income.

Investors has a right in the investment's performance and profit when they jointly control the entity or have a significant influence upon it. The investor recognizes this right by expanding the scope of its financial statements to include its share of the profit or loss of the investee. As a result, changes from equities on associates or joint ventures are traced up to date on investors' financial statements. Calculation of the carrying amount of an associate based on the equity method can be seen in Figure 2.

Figure 2: The process of the equity method



At first, acquisition cost and differences between the acquisition cost of the investment and the entity's share of the net fair value of the identifiable net assets, liabilities, and contingent liabilities of the associate or joint venture are recognized. However, there are some rules when recognizing values. When the cost is higher there is goodwill and when the cost is lower there is a profit. Amortisation is included in the acquisition cost of a joint venture or associate. However, accounting standards do not allow the amortisation of goodwill.

Goodwill arising from the recognition of associates is not recognized as a separate item in the financial statement of the investor and is included in the carrying amount of the associate. In case of negative goodwill, differences are included in the investor's income.

If the joint venture or associate reports losses, then the investor should decrease the carrying amount in proportion to its share. However, if the investor's share of loss is equal to or more than the carrying amount, the investor does not recognize the exceeding amount.

The determination of impairment is crucial to ensuring that financial statements are relevant and faithfully represented. Investors should consider impairment indicators and prepare their financial statements accordingly. IAS Standard 36 Impairment of Assets aims to apply the principle to ensure that an asset is not carried at more than its recoverable amount. Indicators of impairment can be internal or external. External indicators are observable indications that the asset's value has declined during the period significantly and more than expected: Significant changes, including future changes, in the technological, market, economic or legal environment in which the entity operates, Increased market rates affect the discount rate used in calculating an asset's value in a user and decrease the asset's recoverable amount materially and, the carrying amount of the net asset of the entity is more than its market capitalization (IAS 36.12). Whereas internal indicators are evidence of obsolescence or physical damage to an asset, the economic performance of the asset is way below that expected and, significant adverse changes in the entity have taken place during the period. Goodwill included in the acquisition is a part of the whole, therefore does not subject to impairment test separately.

Elimination of In-Group Transactions based on Equity Method

When preparing consolidated financial statements, all in-group transactions should be eliminated; while on the equity method, only in-group "profit elements" are eliminated. Unlike the consolidation method, the equity method does not require merging all income elements (such as sales and cost of goods sold), therefore, in-group transactions do not cause duplication. In the equity method, the only element that is included in the investor's financial statements is the change in the associate's comprehensive income and loss. The investor's share of unrealized profits or losses arising from upward (the sales of the associate to the investor) and downward (the sales of the investor to the associate) transactions must be eliminated. The equity method requires partial elimination, instead of full elimination, which is applied in the consolidation method.

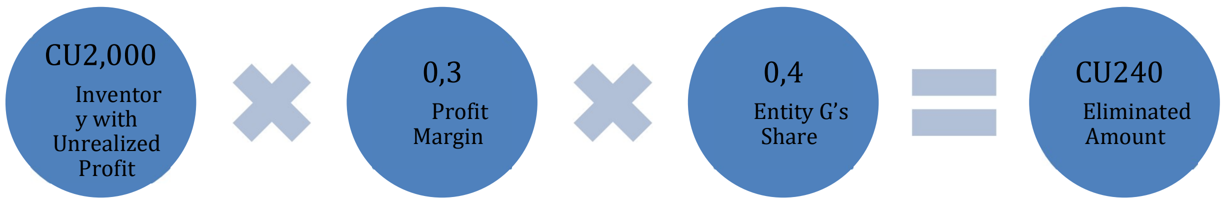
EXAMPLE 3

G Entity owns 40% shares of Entity C’s. In 2021, Entity G sold CU10,000 merchandise to Entity C and the profit margin was 30%. Entity C sold CU8,000 of its 10,000 CU merchandise to a third party in 2021, leaving it with just CU2,000. At the end of 2021, Entity C holds CU2,000 goods on hand. Please consider this transaction in line with IAS 28, calculate the eliminated amount and make the required journal entries.

SOLUTION 3

This is an example of a downward transaction. CU10,000 was transferred between partners. CU8,000 of it was sold to a third party so this amount is a realized profit; whereas CU2,000 is an unrealized profit. Therefore, CU2,000 should be eliminated. Considering the profit margin and share ratio of Entity G, the elimination process should be calculated and recognized as follows (see Figure 3).

Figure 3: Calculation of In Group Transaction Eliminated Amount



Dr. Profit/Loss shares in Associates 240

Cr. Investment in C 240

Discontinuing the Use of Equity Method

The investor derecognizes associates or joint ventures when it loses their significant influence upon the investee. This could happen as follows:

- Joint venture or associate becomes a subsidiary.
- Joint venture or associate is partially or fully disposed of.

- In the case that the entity decides not to use the equity method, the entity shall account for all amounts previously recognized in other comprehensive income about that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.

EXAMPLE 4

On 1 January 2021, Entity A owns Entity B's %35 shares and has a significant influence on Entity B. On the acquisition date, Entity B's carrying amount of net assets is CU900,000 and the fair value is CU1,100,000.

a) Entity A transferred CU475,000 for %35 shares.

b) Entity A transferred CU350,000 for %35 shares.

c) On December 31, 2021, Entity B reports CU60,000 profit and pays CU20,000 dividends in cash.

d) Entity B has "Financial Assets Held for Sale" and its fair value rises CU10,000 and it is recognized in other comprehensive income.

e) Entity B revalued its property, plant and equipment and reports CU15,000 in the other comprehensive income.

SOLUTION 4

a) Entity A should compare the transferred amount to the fair value of Entity B.

Entity A's share on Entity B's fair value is	CU385,000 (CU1,100,000 * 0,35).
Transferred Amount	CU475,000

When the transferred amount exceeds the fair value, goodwill arises but Entity A does not recognize goodwill as a separate item and includes it in the carrying amount of the investment. In this example, there is CU90,000 goodwill arising from the purchase. In this regard, Entity A should make the following journal entry:

	Dr.	Cr.
Dr. Investment in B	475,000	
Cr. Cash		475,000

b) Entity A’s share on Entity B’s fair value is CU385,000 (CU1,100,000 * 0,35).

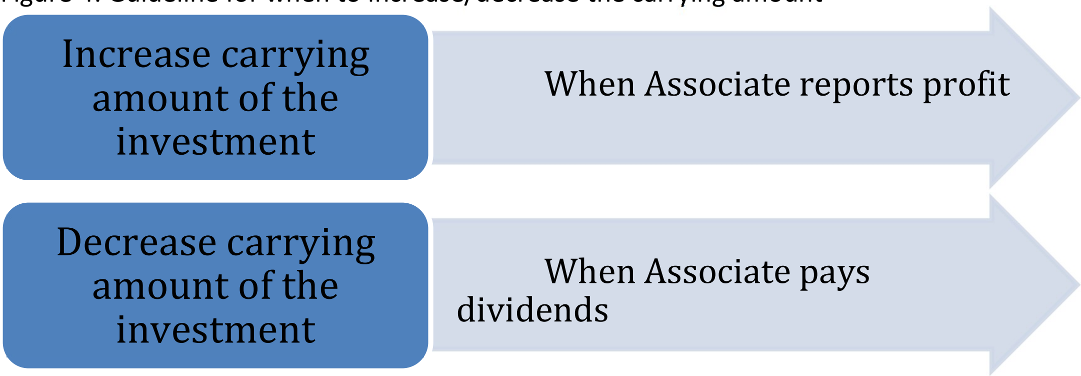
Transferred Amount CU350,000

When the transferred amount is less than the fair value then negative goodwill (gain from a bargain purchase) arises and the investor should recognize this amount as profit and loss:

Dr. Investment in B	385,000	
Cr. Cash		350,000
Cr. Gain from a bargain purchase		35,000

c) Based on the equity method, investors should apply guidelines in case of investee reported profits and paying dividends in Figure 4.

Figure 4: Guideline for when to increase/decrease the carrying amount



In this example, Entity A shall make two journal entries. First, Entity B’s reported profit based on its share shall be recognized. Entity A has %35 shares, therefore it should recognize CU21,000 on the total CU60,000 profit:

Dr. Investment in B	21,000
Cr. Profit of associates measured with equity method	21,000

Entity B pays CU20,000 dividends and Entity A should recognize CU7,000 because of its %35 shares. In the case of paying dividends, the carrying amount of associates is decreased.

Dr. Cash	7,000	
Cr. Investment in B		7,000

d) Entity A should recognize the increase in "Financial Assets Held for Sale" in the proportion of its share in Entity B. Therefore, Entity A should record CU3,500 on the total CU10,000 appreciation.

Dr. Investment in B	3,500	
Cr. Fair value gain on financial assets held for sale		3,500

e) Entity A recognizes the transaction that causes an increase in Entity B's equity in line with its shares. Entity A recognizes CU5,250 of the total CU15,000 increase on property, plant and equipment due to the revaluation.

Dr. Investment in B	5,250	
Cr. Gains on fixed assets revaluation		5,250