Equity accounting under Ind AS

This article aims to:

- Highlight important considerations for entities accounting investment in associates and joint ventures under the equity method of accounting.

Introduction

Corporates in India covered in Phase I of Ind AS road map have implemented Ind AS from the financial year beginning 1 April 2016, transition date being 1 April 2015. As per Ind AS principles, the companies with investments as joint ventures and associates have to apply equity method of accounting while accounting for such investments in their consolidated financial statements.

The requirements of Ind AS is different from the erstwhile Indian GAAP. Under erstwhile Indian GAAP, companies were not required to prepare consolidated financial statements in case they do not have subsidiaries even though they had investments in associates and joint ventures. Ind AS clarifies that consolidated financial statements have to be prepared by an entity if it has investment in an associate or a joint venture.

Background

Ind AS 28, *Investments in Associates and Joint Ventures,* prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

Ind AS 28 defines 'equity method' as 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 the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

Ind AS 28 is applicable to all the entities that are investors with joint control of, or significant influence over, an investee.

Application of equity method

Under the equity method, the investment is initially recognised at cost and subsequently increased or decreased to recognise:

- The investor's share of the profit or loss of the investee
- The investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income and
- The dividends received from the investee.

An investment in an equity-accounted investee is accounted for under the equity method from the date on which the investor obtains significant influence or joint control over the investee.

Exemptions from equity method

The investor is required to account for investments in associates and joint ventures using the equity method except:

- When the entity is exempt from preparing consolidated financial statements unless it chooses to do so on a voluntary basis
- When all of the following apply:
  - the entity is a wholly owned subsidiary, or is a partially owned subsidiary and its other owners (including those not otherwise entitled to vote) have been informed about, and 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, including stock exchanges and over-the-counter markets
  - the entity did not file, and is not in the process of filing, its financial statements with a regulatory organisation for the purpose of issuing any class of instruments in a public market and
  - the ultimate or any intermediate parent of the entity produces financial statements that comply with Ind AS i.e. in those financial statements, subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110, *Consolidated Financial Statements,* and are available for public use.

Venture capital organisations, mutual funds, unit trusts and similar entities may elect to account for investments in associates and joint ventures at fair value through profit or loss. Additionally, equity accounting is not applied to an investee that is acquired with a view to its subsequent disposal if the criteria are met for classification as held for sale.

Classification as held for sale

An investor would be required to apply Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations* to an investment in an associate or joint-venture meets the criteria to be classified as held for sale. Any retained portion of an investment in an associate or a joint venture that has not been classified as held for sale shall be accounted for using the equity method until disposal of the portion that is classified as held for sale takes place. After the disposal, the retained interest should be accounted for in accordance with Ind AS 109, *Financial Instruments* unless the retained interest continues to be an associate or a joint venture, in which case the entity uses the equity method.

Discontinuing the use of the equity method

An entity should discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture as follows:

1. If the investment becomes a subsidiary, the entity shall account for its investment in accordance with Ind AS 103, *Business Combinations,* and Ind AS 110.
2. If the retained interest in the former associate or joint venture is a financial asset, the entity should measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as a financial asset in accordance with Ind AS 109. The entity should recognise in profit or loss any difference between:
   - The sum of: The fair value of any proceeds from the interests disposed of The fair value of any retained investment The amount reclassified from other comprehensive income and
   - The carrying amount of the investment at the date the equity method was discontinued.
3. When an entity discontinues the use of the equity method, the entity shall account for all amounts previously recognised in other comprehensive income 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.

Thus, when the gain or loss previously recognised in other comprehensive income by the investee would be reclassified to profit or loss on the disposal of the related assets or liabilities and the investor would reclassify the gain or loss from equity to profit or loss.

Practical application areas

While accounting for investments under equity method, an investor has to consider some practical application areas. Some of the significant areas are as follows:

1. **Determination of initial carrying amount**

   The investor may face an issue while determining initial carrying amount of investment under equity method whether the costs directly attributable to the acquisition of an investment in an equity-accounted investee should be included in the initial carrying amount. Internationally, IFRS Interpretations Committee has discussed this issue and noted that the cost of an investment determined in accordance with equity method should comprise purchase price and other costs directly attributable to the acquisition of the investment, such as professional fees for legal services, transfer taxes and other transaction costs.

   The directly attributable costs relating to an acquisition of an investment in an equity-accounted investee normally do not include costs incurred after the acquisition is completed e.g. integration costs and costs to determine the fair value of the investor's share in the investee's net assets.

2. **Treatment of goodwill**

   On acquisition of equity-accounted investee, fair values are attributed to the investee's identifiable assets and liabilities. Any positive difference between the cost of the investment and the investor's share of the fair values of the identifiable net assets acquired is goodwill. As per Ind AS 28, goodwill arising on acquisition of an investee forms part of the carrying amount of the equity accounted investee and is not shown separately. Accordingly, such goodwill is not separately tested for impairment annually as per the requirements of Ind AS 36, *Impairment of Assets* rather the entire carrying value of the investment in the associate or joint venture is tested for impairment as a single asset.

   Any excess in the investor's share in the fair value of identifiable net assets over cost is recognised in equity as capital reserve. The investor's share of depreciation charges to be included with the share of the investee's profit or loss in the investor's financial statements reflects any fair value adjustments for depreciable assets at the date of acquisition. The fair value adjustments are made only for the proportion of net assets acquired.

3. **Contingent consideration**

   Ind AS 103, *Business Combinations* defines contingent consideration as an obligation by the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. Contingent consideration may also include an acquirer's right to the return of previously transferred consideration if certain conditions are met - e.g. a repayment to the acquirer of consideration transferred to the former owners of an acquired business is required if that business does not meet financial or operating targets that were specified in the acquisition agreements.

   While accounting for investment under equity method, an investee would be required to account for contingent consideration arising from the equity accounted investee. Ind AS 28 does not prescribe any specific guidance on the measurement of the cost of acquiring an investment accounted using equity method. However, it prescribes that the procedures used in accounting for subsidiary are also adopted and accounted for acquisition of an investment in an associate or joint venture. In case an entity follows the treatment prescribed in Ind AS 103, then the contingent consideration would be initially recognised at fair value as part of the cost of acquisition. In such cases the subsequent accounting for contingent consideration classified as asset or liability would be as per Ind AS 103.

4. **Potential voting rights**

   Potential voting rights are a common form of rights that may be substantive, for example, call options and if exercised would provide voting rights to an entity. In case an investee has potential voting rights then an issue may arise as to whether potential voting rights would be taken into account while determining significant influence over an investment. Ind AS 110, *Consolidated Financial Statements* has introduced the concept of substantive voting rights. Therefore, while assessing control, potential voting rights have to be evaluated by the barometer of whether those rights are substantive. However, Ind AS 28 does not include the concept of 'substantive voting rights'. As a result, the evaluation of whether significant influence exists is based on whether potential voting rights are currently exercisable and not whether they are substantive. Therefore, the investor would be required to consider the facts and circumstances that affect the potential voting rights in assessing whether the potential voting rights contribute to significant influence.

5. Equity accounted investees that are loss making

As per Ind AS 28, the investor's share of losses of an equity-accounted investee is recognised only until the carrying amount of the investor's equity interest in the investee is reduced to zero. After the investor's interest is reduced to zero, a liability is recognised only to the extent that the investor has an obligation to fund the investee's operations or has made payments on behalf of the investee.

The equity interest in an equity-accounted investee includes, for this purpose, the carrying amount of the investment under the equity method and other long-term interests that in substance form part of the entity's net investment in the associate or joint venture - e.g. a loan for which settlement is neither planned nor likely to happen in the foreseeable future. Other long-term interests do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists - e.g. secured loans. When losses recognised under the equity method exceed the investor's investment in ordinary shares, the excess is applied to other components of the investor's interest in an equity-accounted investee in the reverse order of their seniority (i.e. priority in liquidation).

6. Unrealised profits and losses

As per Ind AS 28, gains and losses resulting from transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture. In a transaction with equity accounted investee, the unrealised profits/losses on transactions with equity-accounted investees are eliminated to the extent of the investor's interest in the investee, regardless of whether that unrealised profit is in the investor, a subsidiary in the same group as the investor, or the investee - i.e. in both 'upstream' and 'downstream' transaction. If a downstream transaction results in a loss, then no portion of the loss is eliminated to the extent that it provides evidence of a reduction in the net realisable value or of impairment of the asset to be sold or contributed. If an upstream transaction provides evidence of a reduction in the net realisable value of the assets to be purchased, then the investor recognises its share in those losses.

The issue may arise for the investor when a downstream transaction with an equity-accounted investee for which its share of the gain arising from the transaction exceeds its interest in the investee. The investor would have to choose an approach for such an excess, and should be applied consistently to all downstream transaction with equity accounting investee.

Consider this

- The definition of an associate is based on significant influence, which is the power to participate in the financial and operating policy decisions of an entity.
- Potential voting rights that are currently exercisable are considered in assessing significant influence.
- In applying the equity method, an investee's accounting policies should be consistent with those of the investor.
- If an equity-accounted investee incurs losses, then the carrying amount of the investor's interest is reduced but not to below zero. Further losses are recognised as a liability by the investor only to the extent that the investor has an obligation to fund losses or has made payments on behalf of the investee.
- Unrealised profits and losses on transactions with associates are eliminated to the extent of the investor's interest in the investee.
- On the loss of significant influence or joint control, the fair value of any retained investment is taken into account in calculating the gain or loss on the transaction that is recognised in profit or loss. Amounts recognised in other comprehensive income are reclassified to profit or loss or transferred within equity as required by other Ind AS.