Institute of Chartered Accountants of New Zealand

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ACCOUNTING FOR INVESTMENTS IN ASSOCIATES

Issued by the Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand

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This Financial Reporting Standard is a regulation for the purposes of the Regulations (Disallowance) Act 1989

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This Financial Reporting Standard replaces parts of SSAP-8: Accounting for Business Combinations (1990). However, the corresponding parts of SSAP-8 will continue to apply to general purpose financial reports until an entity elects to comply with this Standard as permitted by the Financial Reporting Act 1993 section 27(7), or until this Standard takes effect, whichever is sooner.

This Financial Reporting Standard should be read in the context of the Explanatory Foreword to General Purpose Financial Reporting issued by the Council of the Institute of Chartered Accountants of New Zealand.

The Accounting Standards Review Board has approved FRS-38: Accounting for Investments in Associates, for the purposes of the Financial Reporting Act 1993, to apply to the following entities (as respectively defined in the Act): All reporting entities and groups, the Crown and all departments, Offices of Parliament and Crown entities, and all local authorities.

1 INTRODUCTION

COMMENTARY

1.1 This Standard deals with the accounting by investors for entities that are subject to the significant influence of the investors. Such entities are referred to as associates of the investors. Subject to certain limited exceptions, this Standard requires an investor to use the equity method to account for its investments in associates.

1.2 Under the equity method, an investment in an associate is recognised in the investor's statement of financial position at cost when the investment is acquired. At each subsequent reporting date, the carrying amount of the investment is adjusted for changes in the investor's share of the net assets of the associate that have occurred since the last reporting date (or date of acquisition in the year the investment is acquired). The investor's statement of financial performance includes the investor's share of the net surplus or deficit of the associate and the investor's statement of movements in equity includes the investor's share of the total recognised revenues and expenses of the associate.

1.3 The rationale for application of the equity method is as follows. In some cases, the relationship between an investor and its investee does not extend beyond an investor/investee relationship. However, in other cases, a special relationship between the investor and the investee exists, which is characterised by the investor's significant influence over an investee. Where significant influence exists, the investee is an associate and the investor has the capacity to affect substantially

either, or both, the associate's operating and financing policies. Consequently, the investor should be able to achieve broad consistency, in the areas of mutual interest, in the implementation of policies; and also achieve some protection from changes in the operating and financing policies of the associate which could adversely affect it. Since the associate's performance and the economic resources underlying the investment may have a significant effect on the investor, information about them should be reported in the financial statements of the investor through application of the equity method.

1.4 In applying the equity method, the investor's share of the post-acquisition net assets of the associate is determined by the investor's ownership interest in the associate. An ownership interest is the percentage of the equity of an investee attributable to an investor. In most cases, significant influence will directly relate to the level of ownership interest held. However, in rare cases, an investor may have a zero ownership interest in an associate. In such circumstances, the investor will not apply the equity method but must still meet the requirements under this Standard to disclose certain information regarding the associate where the relevance of such information is not limited to where the equity method has been applied. References in this standard to "investor", "investee", and "investment in an associate" include relationships where there is significant influence and zero ownership interest.

1.5 In this Standard, the equity method is viewed as a method of determining the carrying amount of an investment in an associate and the amount of revenue from the investment.

1.6 Financial reporting standards are paragraphs in bold type-face in this Standard. Where appropriate, interpretative commentary paragraphs in plain type-face follow the financial reporting standards.

2 APPLICATION

STANDARD

2.1 This Standard applies to all entities having investments in one or more associates.

COMMENTARY

2.2 Where an investor has investments in one or more associates, this Standard requires the investor to apply the equity method in:

(a) any consolidated financial statements prepared by the investor; or

(b) in cases where the investor does not prepare consolidated financial statements, in either the investor's own financial statements or a separate set of financial statements.

STANDARD

2.3 The financial reporting standards set out in this Standard apply to all financial reports where such application is of material consequence. A statement, fact, or item is material if it is of such a nature or amount that its disclosure, or the method of treating it, given full consideration of the circumstances applying at the time the financial report is completed, is likely to influence the users of the financial report in making decisions or assessments.

2.4 This Standard applies to general purpose financial reports covering periods ending on or after 31 December 2002.

3 STATEMENT OF PURPOSE

COMMENTARY

3.1 The purpose of this Standard is to:

(a) prescribe the circumstances in which investors are to use the equity method to account for investments in associates;

(b) prescribe how the equity method is to be applied; and

(c) specify minimum disclosures in respect of investments in associates.

4 DEFINITIONS

STANDARD

The following terms are used in this Standard with these meanings:

4.1 "Acquisition" means obtaining an asset, a group of assets, or net assets.

COMMENTARY

4.2 In the context of this Standard, an acquisition means obtaining an ownership interest in another entity. An acquisition of an ownership interest is not limited to an acquisition that gives rise to significant influence over another entity. Acquisitions cover ownership interests of any level that have been obtained in another entity. Acquisitions of ownership interests that do not give rise to significant influence over another entity become subject to the requirements of this Standard retrospectively when significant influence has been established through a step-acquisition.

STANDARD

4.3 "Acquisition date" is the date on which a transferee becomes entitled to the benefits associated with an asset, a group of assets, or net assets.

COMMENTARY

4.4 In the context of this Standard, acquisition date is the date on which an ownership interest in another entity is transferred to an investor. This is the date on which rights to that interest are transferred to the investor. It is the date on

which there has been a transfer in substance, and it is not necessarily the actual date identified in any formal sale agreement or other similar documentation.

4.5 Although the acquisition date is the specific date on which the transfer of assets occurs, the parties may, for convenience, designate a date close to that date as the acquisition date; for example, the calendar month-end that is nearest to the specific transfer date. In such case, the cost of acquisition is to be adjusted for any imputed interest corresponding to the time difference between the designated acquisition date and the actual acquisition date. However, a designated acquisition date may be treated as the actual acquisition date only where the fair values of the identifiable assets and liabilities at the designated acquisition date are not materially different to their values at the actual acquisition date.

4.6 The terms "pre-acquisition" and "post-acquisition" are to be understood in relation to the definition of acquisition date.

STANDARD

4.7 "Associate" is an investee (not being a subsidiary of the investor or joint venture entered into by the investor) over which the investor has the capacity to exercise significant influence.

COMMENTARY

4.8 An associate may be an entity of any form that is subject to the significant influence of an investor. For example, an associate includes any interest held by an investor in a partnership where the investor has the capacity to exercise significant influence over that partnership. However, the definition of an associate does not cover levels of interest that give rise to a controlling influence. Controlled entities are subsidiaries and are accounted for in accordance FRS-37: *Consolidating Investments in Subsidiaries*.

STANDARD

4.9 "Capacity" is an ability or power, whether direct or indirect, and includes an ability or power that is presently exercisable in accordance with a formal constitution, agreement, or practice, whether or not such ability or power is legally enforceable.

4.10 "Carrying amount" is the amount at which an asset or liability is included in the statement of financial position.

4.11 "Consolidated financial statements" are the financial statements of the group presented without regard to the legal boundaries of the separate entities that are consolidated.

COMMENTARY

4.12 Consolidated financial statements include the assets, liabilities, revenues and expenses of the parent and its consolidated subsidiaries.

STANDARD

4.13 "Cost of acquisition" is the aggregate of the following amounts:

(a) the value of consideration attributable to the acquisition plus any directly attributable costs; and

(b) the fair value of the asset, group of assets, or net assets obtained as a result of the acquisition to the extent that they have been acquired through a donation or subsidy.

COMMENTARY

4.14 Commentary providing guidance on the meaning of cost of acquisition is set out in FRS-36: *Accounting for Acquisitions Resulting in Combinations of Entities or Operations*.

STANDARD

4.15 "Discount on acquisition" is the excess of the investor's share of the fair value of the recognised identifiable assets and liabilities over the cost of acquisition.

COMMENTARY

4.16 Discount on acquisition is sometimes referred to as negative goodwill.

STANDARD

4.17 "Equity method" is the method of accounting whereby an investment in an investee is initially recognised at cost and is adjusted thereafter for post-acquisition changes in the investor's share of the net assets of the investee, with:

(a) the investor's share of the net surplus or deficit of the investee recognised in the investor's statement of financial performance; and

(b) the investor's share of the total recognised revenues and expenses of the investee recognised in the investor's statement of movements in equity.

4.18 "Fair value" is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

COMMENTARY

4.19 Commentary providing guidance on the meaning of fair value in relation to acquisitions is set out in FRS-36: *Accounting for Acquisitions Resulting in Combinations of Entities or Operations*.

STANDARD

4.20 "Goodwill" is the excess of the cost of acquisition over the investor's share of the fair value of the recognised identifiable assets and liabilities.

4.21 "Group" is an entity that comprises an investor and all of its subsidiaries.

4.22 "Identifiable assets and liabilities" consist of:

(a) the individual assets and liabilities that correspond to the acquisition, that are capable of being disposed of, or settled, individually; and

(b) planned amounts for terminating or reducing activities required to be recognised as a provision under paragraph 5.11 of FRS-36: *Accounting for Acquisitions Resulting in Combinations of Entities or Operations*.

COMMENTARY

4.23 Commentary providing guidance on the meaning of identifiable assets and liabilities is set out in FRS-36: *Accounting for Acquisitions Resulting in Combinations of Entities or Operations*.

STANDARD

4.24 "Investee" is an entity in which an investor has an ownership interest.

STANDARD

4.25 "Investor" is an entity that has an ownership interest in the equity of another entity or that has acquired an operation.

COMMENTARY

4.26 In the context of this Standard, an investor is limited to an entity that has an ownership interest in the equity of another entity.

STANDARD

4.27 "Joint venture" is that form of arrangement in which there is a contractual association, other than a partnership, between two or more parties to undertake a specific business project in which the venturers have several liability in respect of the costs and liabilities of the project and share any resulting output.

COMMENTARY

4.28 SSAP-25: *Accounting for Interests in Joint Ventures and Partnerships* deals with the accounting by participants for interests in joint ventures.

STANDARD

4.29 "Market value accounting" is the method of accounting whereby an investment is recognised in the investor's statement of financial position at net market value and changes in net market value are recognised as revenues or expenses in the period in which the changes occur.

4.30 "Net market value" is the fair value at a particular date less the costs of disposal that could reasonably be anticipated at that date.

COMMENTARY

4.31 In determining net market value it is not appropriate for the costs of disposal to be discounted because they will already be expressed as a current value. Other terms commonly used to describe net market value are "net current value" and "net realisable value".

STANDARD

4.32 "Ownership interest" is the percentage of the equity of an investee attributable to an investor, whether the equity is attributable to the investor directly, or indirectly through its subsidiaries.

COMMENTARY

4.33 Commentary providing guidance on the meaning of ownership interest is set out in FRS-37: *Consolidating Investments in Subsidiaries*.

4.34 The level of ownership interest held by an investor in an associate determines the investor's share of the post-acquisition net assets of the associate when applying the equity method.

4.35 When there are unexercised instruments that are currently exercisable and that entitle a holder to obtain a further interest in an associate, the ownership interest for the purposes of this Standard is the ownership interest currently held by the investor.

STANDARD

4.36 "Recoverable amount" is the greater of:

(a) net market value; and

(b) value-in-use.

4.37 "Significant influence" is the capacity of one entity to affect substantially, but not unilaterally determine, either or both the financial and operating policies of another entity.

COMMENTARY

4.38 Whether an investor has significant influence over an investee will need to be decided in the light of the prevailing circumstances. The existence of significant influence depends upon substance and not form.

4.39 Significant influence will normally stem from voting power held by an investor in an investee. In some cases the existence of significant influence as a result of voting power will be conclusive, while in other cases it will need to be supported by satisfying other conditions. In deciding whether the investor's voting power gives rise to significant influence over the investee, it may be necessary to consider the distribution of the balance of the voting power. For example, in the case of a company, whether the balance of the voting power is held in a few large

equity holdings or distributed over a large number of small equity holdings needs to be considered in determining whether the investor exercises significant influence.

4.40 Where an investor holds 20 per cent or more of the voting power in an investee, this could lead, in the absence of evidence to the contrary, to a presumption that the investor has significant influence over the investee. However, this percentage is not intended as an absolute cut-off point. In certain cases, an investee will qualify as an associate even if the investor's voting power in the investee is less than, or has fallen below, 20 per cent. The converse also applies.

4.41 Where there are favourable unexercised instruments exclusively held by an investor which will give the investor significant influence when exercised, such influence may need to be determined on the basis that the unexercised instruments have been exercised. In the particular circumstances where such instruments exist and they are currently exercisable, such influence will need to be determined on the basis that the instruments have been exercised.

4.42 The following is a list of some of the factors which, singly or in combination, may indicate the existence of significant influence:

(a) the investor's voting power;

(b) representation on the governing body;

(c) dependence on technical information;

(d) participation, in other ways, in policy-making decisions;

(e) economic dependency, including material inter-entity transactions;

(f) interchange of managerial personnel; and

(g) participation in decisions as to dividends or other distributions.

4.43 In the context of significant influence there arises the question whether the same entity could simultaneously qualify as an associate of one investor and as a subsidiary or associate of another investor. A substantial or majority ownership of the shares (or their equivalent) of an investee by another entity will normally preclude the ability of the first investor to exercise significant influence but will not always do so.

4.44 It is unlikely that significant influence would exist or would continue to exist where an investee operates under severe long-term restrictions which impair significantly its ability to make distributions to the investor, for example, restrictions on the repatriation of dividends.

4.45 The investor's voting power in an associate needs to be distinguished from the investor's ownership interest in that associate. Voting power often arises from ownership interest but is different to it in nature. Voting power will usually be important in determining whether significant influence exists, although it is not a necessary component of significant influence. Ownership interest is relevant when

measuring the carrying amount of the investment based on the investor's share of the results and net assets of the associate under the equity method.

STANDARD

4.46 "Subsidiary" is an entity that is controlled by another entity.

COMMENTARY

4.47 A subsidiary may be an entity of any form that is controlled by an investor. For example, a subsidiary includes any interest held by an investor in a partnership where the investor controls that partnership. The term "controlled" is to be understood in relation to the definition of control set out in FRS-37: *Consolidating Investments in Subsidiaries*.

STANDARD

4.48 "Value-in-use" is the present value of the net future cash flows obtainable from an asset's continuing use and ultimate disposal.

COMMENTARY

4.49 Estimating the value-in-use of an investment in an associate involves:

(a) estimating the future cash inflows and outflows to be derived from continuing to hold the investment and from its ultimate disposal; and

(b) determining an appropriate discount rate.

4.50 Judgement is necessary to determine value-in-use because estimates are required of future cash flows and an appropriate discount rate. Future cash flows refer to those directly identifiable with the investment. These will include expected dividend receipts and other similar cash flows between the investee and the investor. Relevant future cash flows will also include expected cash flows accruing to the investor with regard to third party transactions where these are directly attributable to the investor's interest in the investee.

4.51 The direct cash flows described in paragraph 4.50 may comprise cash flow synergies expected as a direct consequence of the investment. Examples are savings through rationalisation of administrative resources or variable margins for sales of products or services of the investor to purchasers of the investee's products or services who are not previous purchasers from the investor.

5 FINANCIAL REPORTING

Method of Accounting Required

STANDARD

5.1 Subject to paragraphs 5.3 and 5.5, an investor that has, as at its reporting date, one or more associates, must apply the equity method to account for the

interest in each associate either in:

(a) the investor's consolidated financial statements, where the investor has subsidiaries and prepares consolidated financial statements; or

(b) the investor's own financial statements or in a separate set of financial statements in addition to the investor's own financial statements, where the investor does not have subsidiaries or does not prepare consolidated financial statements.

COMMENTARY

5.2 Where the investor does not have any subsidiaries at its reporting date and elects to equity account in its own financial statements, it is appropriate that the statements be described as the financial statements of the entity and the associate(s).

STANDARD

5.3 An investor is not required to apply the equity method to account for an investment in an associate when a provision exists under statute that expressly exempts the investor from the requirement to prepare consolidated financial statements and the investor does not prepare consolidated financial statements.

COMMENTARY

5.4 Where an investor has subsidiaries as well as associates but is exempt from preparing consolidated financial statements under section 13(2) of the *Financial Reporting Act 1993* because it is itself a wholly New Zealand-owned subsidiary, this standard does not require the investor to apply the equity method to its associates.

STANDARD

5.5 An investor must not apply the equity method to account for an investment in an associate in circumstances where:

(a) at the date significant influence is obtained, the investor is obligated to relinquish significant influence within one year; or

(b) by the earlier of three months after the date significant influence is obtained or the date when the annual financial statements are approved, the investor has entered into a binding arrangement to relinquish significant influence within one year from the date significant influence is obtained; or

(c) market value accounting of the investment in the associate is applied and is expressly permitted or required under another financial reporting standard.

5.6 An investment in an associate that is not accounted for using the equity method because of the requirements in paragraph 5.5(a) and (b) of this Standard, must be disclosed as a current asset in the statement of financial position of the investor.

COMMENTARY

5.7 The restrictions from equity accounting temporarily held investments in associates in circumstances (a) and (b) of paragraph 5.5 may apply where there is a committed part-disposal of the investment. The restrictions are not limited to circumstances where there is a committed full-disposal. The restrictions will apply in the case of a committed part-disposal where the part-disposal will result in the investee no longer being an associate. For example, if an investor acquired a 40% investment in an investee, thereby making the investee an associate, and the investor was committed to dispose of three quarters of this investment, thereby making the investee no longer an associate, equity accounting would be prohibited.

5.8 This Standard prohibits an investor from equity accounting investments in associates in circumstances when market value accounting of such investments is applied and is expressly permitted or required under another financial reporting standard. For example, market value accounting will be adopted for investments in associates held by investors such as life insurers and superannuation schemes in accordance with applicable financial reporting standards.

Initial Application of the Equity Method

STANDARD

5.9 When an investment in an associate is acquired and the investment is accounted for using the equity method:

(a) the investment must be recognised at its cost of acquisition;

(b) the fair values of the identifiable assets and liabilities of the associate must be determined at the acquisition date; and

(c) any goodwill or discount on acquisition must be identified but not separately recognised.

COMMENTARY

5.10 An investment in an associate is initially recognised at the cost of acquisition. No adjustment should be made on initial recognition for any attributable goodwill or discount on acquisition element. However, the fair values of the identifiable assets and liabilities of the associate should be determined as at the acquisition date to identify any goodwill or discount on acquisition arising. This is to ensure that the effects of goodwill amortisation and/or amended asset depreciation/amortisation amounts can be taken into account in determining post-acquisition net surpluses or deficits of the associate for the purposes of application of the equity method. Guidance on assessment of fair values and the measurement of goodwill or discount

on acquisition is set out in FRS-36: *Accounting for Acquisitions Resulting in Combinations of Entities or Operations*.

STANDARD

5.11 When an investee becomes an associate subsequent to initial acquisition of an ownership interest and the investment in the investee is accounted for using the equity method:

(a) the carrying amount of the investment must be adjusted to that amount which would have been the carrying amount had it been an investment in an associate since the initial acquisition date;

(b) the amount of the adjustment made to reflect the share of net surpluses or deficits of the associate since the initial acquisition date must be recognised in the statement of financial performance; and

(c) the amount of the adjustment made to reflect any other movements in equity of the associate since the initial acquisition date must be recognised in the statement of movements in equity.

COMMENTARY

5.12 The purchase of an additional ownership interest or the occurrence of other events or transactions may result in an investor obtaining significant influence over an investee.

5.13 Where an investor obtains an ownership interest in an associate in discrete steps, say, in two tranches of 10 per cent and 15 per cent respectively, the carrying amount of the investment is determined by applying the equity method in respect of each separate tranche as at the acquisition date of each tranche. This requires a step-by-step comparison to be made of the cost of each tranche with the investor's percentage interest in the fair values of the identifiable assets and liabilities at each step. The amount of the adjustment to the carrying amount of the investment is determined by reference to the investor's share of net surpluses of the investee, determined in accordance with paragraph 5.23, and the investor's share of other post-acquisition revenues and expenses of the investee arising subsequent to the acquisition date of each particular tranche. These adjustments are illustrated in Appendix 2 to this Standard.

5.14 The requirement for a step-by-step comparison applies only with regard to material acquisitions. When there are a number of immaterial acquisitions, it is appropriate to group a series of such acquisitions into a single step, and treat the series in the same way as a single material acquisition.

5.15 It may not always be possible to directly assess fair values of the investee's identifiable assets and liabilities with regard to acquisitions of ownership interests before significant influence is obtained. This may be the position in circumstances when formal fair value assessments were not undertaken at the times of acquisitions that did not lead to significant influence and an assessment of fair values can only

be made retrospectively. In such cases, it may be appropriate to estimate those fair values on the basis of carrying amounts at those points in time, adjusted in a manner consistent with the relationship between carrying amounts and fair values at the point significant influence is obtained.

5.16 In some cases, an investee may become an associate subsequent to the acquisition of an ownership interest by the investor in circumstances where the investment has previously been accounted by the investor on a market value basis. In such circumstances, the adjustment necessary to comply with paragraph 5.11 will need to be modified to achieve the same position as if the investment had always previously been accounted by the investor at cost. This adjustment is illustrated in Appendix 3 to this Standard.

Subsequent Application of the Equity Method

STANDARD

5.17 In each financial year that the equity method is applied, the carrying amount of an investment in an associate must be:

(a) increased or decreased to recognise the investor's share of the post-acquisition net surplus or deficit of the associate determined in accordance with paragraph 5.23;

(b) decreased for the amount of all dividends received or receivable from the associate; and

(c) increased or decreased to recognise the investor's share of post-acquisition movements in the associate's equity, where such movements have not been recognised previously in the statement of financial performance of the associate, or otherwise recognised in the carrying amount of the investment.

COMMENTARY

5.18 When an investment in an investee is not accounted for under the equity method, the investor recognises dividends received or receivable from the investee as revenue in its own financial statements. However, under the equity method, dividends received or receivable from an associate should be deducted from the carrying amount of the investment so that recognition of this portion of the share of surpluses of the associate is not duplicated.

5.19 Where the associate revalues all or some of its assets after the investor has acquired its ownership interest and that revaluation recognises asset values already reflected in the investor's cost of acquisition and thus the carrying amount of the investment, the carrying amount is not adjusted to reflect this movement in the associate's equity.

STANDARD

5.20 Subject to paragraph 5.53, in each financial year that the equity method is applied, the investor's share of the post-acquisition net surplus or deficit of the associate determined in accordance with paragraph 5.23 must be recognised in the statement of financial performance, and the investor's share of other post-acquisition revenues and expenses of the associate must be recognised in the statement of movements in equity. The investor's share of the post-acquisition net surplus or deficit must be recognised as a single amount, net of any tax and extraordinary items, as a component of operating surplus before tax.

COMMENTARY

5.21 The investor's share of the post-acquisition net surplus or deficit of the associate is to be included in the investor's operating surplus before tax on a net of tax and extraordinary items basis. The consequence is that the amounts of tax and extraordinary items recognised in the investor's statement of financial performance will exclude amounts of tax and extraordinary items relating to associates.

5.22 The investor's share of other post-acquisition revenues and expenses of the associate to be recognised in the investor's statement of movements in equity will include the investor's share of movements in any asset revaluation or foreign currency translation reserves maintained by the associate and the investor's share of adjustments arising from any fundamental errors.

STANDARD

5.23 In applying the equity method, the investor's share of the post-acquisition net surpluses or deficits of the associate must be determined after adjustments for:

- **(a) distributions to preference equity holders;**
- **(b) amortisation of goodwill;**
- **(c) revisions in revenues and expenses resulting from:**
  - **(i) discount on acquisition; and/or**
  - **(ii) differences between the fair values of the identifiable assets and liabilities of the associate at acquisition date and the carrying amounts of assets and liabilities recognised by the associate in its own financial statements;**
- **(d) different accounting policies; and**
- **(e) unrealised gains or losses arising on inter-entity transactions.**

COMMENTARY

5.24 If, for example, an associate has outstanding cumulative preference shares, the investor computes its share of the post-acquisition net surpluses or deficits of

the associate after adjusting for preference dividends, whether or not the dividends have been declared.

5.25 In determining the investor's share of the post-acquisition net surpluses or deficits of the associate, the net surpluses or deficits should be notionally adjusted to reflect:

(a) goodwill amortisation or revisions in revenues and expenses resulting from discount on acquisition; and

(b) fair value differences.

For example, an adjustment may be required for depreciation, as a revision in depreciation can result from both a discount on acquisition and a fair value difference.

5.26 Adjustments to the investor's share of the net surpluses or deficits of the associate for amortisation of goodwill or a revision of revenues and expenses resulting from a discount on acquisition, should be determined in accordance with the guidance set out in FRS-36: *Accounting for Acquisitions Resulting in Combinations of Entities or Operations*.

5.27 Adjustments necessary in cases of different accounting policies and unrealised gains or losses arising on inter-entity transactions are explained in paragraphs 5.33 and 5.35 respectively.

STANDARD

5.28 In applying the equity method, the investor's share of the post-acquisition movements in the net assets of the associate must be determined in accordance with the investor's ownership interest in the associate.

5.29 In applying the equity method in the case of an associate that is a parent entity, the investor's share of the post-acquisition movements in the net assets of the associate must be based on the net assets recognised in the associate's consolidated financial statements.

Reporting Dates

STANDARD

5.30 Wherever practicable, the financial information used for the purposes of accounting for an investment in an associate using the equity method must be drawn up to the same reporting date as the investor's financial statements.

5.31 Where the financial information used for the purposes of accounting for an investment in an associate using the equity method does not cover the same reporting period as that of the investor's financial statements, the following requirements must be met:

(a) the associate's financial information used must cover a reporting period closest to that of the investor's financial statements;

(b) the difference between reporting dates must be no more than three months except in rare circumstances where:

(i) statute fixes an annual balance date of an associate greater than three months from the reporting date of the investor's financial statements; and

(ii) no reliable interim financial information for the associate covering a reporting period not more than three months different to that of the investor is able to be obtained; and

(c) adjustments must be made for the effects of significant transactions or other events that occur during the portion of those reporting periods that does not overlap where such transactions or events would otherwise have been reflected in the carrying amount of the investment in the associate had the financial statements of the associate used in applying the equity method been drawn up to the same reporting date as the investor's financial statements.

COMMENTARY

5.32 The requirements covering the reporting date of financial statements of an associate used in applying the equity method are, in substance, identical to those covering the reporting date of financial statements of a subsidiary used in preparing consolidated financial statements. Commentary providing guidance on these requirements is set out in FRS-37: *Consolidating Investments in Subsidiaries*.

Different Accounting Policies

STANDARD

5.33 In applying the equity method, where the accounting policies adopted by an associate are different to those adopted by the investor and are not required to be adopted under another financial reporting standard, adjustments must be made, where possible, to achieve consistency with the accounting policies of the investor.

COMMENTARY

5.34 The requirement in paragraph 5.33 applies only in circumstances when the difference in the associate's policies would materially affect amounts to be included in the investor's financial statements through application of the equity method.

Inter-Entity Transactions

STANDARD

5.35 In applying the equity method, any unrealised gains or losses arising on transactions between the investor or subsidiary of the investor and an associate, or between two associates of the investor must be eliminated from the financial statements of the investor.

COMMENTARY

5.36 Where an unrealised gain or loss exists in the associate's financial statements as a consequence of a transaction between the associate and the investor or subsidiary of the investor, 100% of the attributable gain or loss should be eliminated before calculation of the investor's share of the associate's net surplus or deficit. Where an unrealised gain or loss exists in the financial statements of the investor or subsidiary of the investor, a percentage of the gain or loss equal to the investor's ownership interest in the associate should be eliminated. Entries to achieve these eliminations are illustrated in Appendix 4 to this Standard.

5.37 Where an unrealised gain or loss arises on a transaction between two associates of the investor, a percentage of the gain or loss equal to the product of the investor's ownership interest in each of the associates should be eliminated. For example, where an associate in which a 25% ownership interest is held, transacts with an associate in which a 40% ownership interest is held, 10% (.25 × .4) of the unrealised gain or unrealised loss should be eliminated.

Cross-Holdings Between Investor and Associate

STANDARD

5.38 In applying the equity method, where an associate holds an interest in the net assets of the investor, the carrying amount of the investment in the associate must be reduced by an amount representing the investor's indirect holding in its own net assets. An equivalent adjustment must be made to the equity of the investor.

COMMENTARY

5.39 When the investor has an indirect holding in itself arising from a cross-holding, adjustments are needed to eliminate, from the investor's share of the change in net assets of the associate, the investor's proportionate share of that part of its own change in net assets which has been recognised by the associate.

5.40 Where the cross-held associate does not apply the equity method to its interest in the investor, if no adjustment is made, a double counting will arise due to the inclusion of dividends received or receivable by the associate from the investor included in the associate's increase in net assets. Where the cross-held associate applies the equity method to its interest in the investor, if no adjustment is made, a double counting will arise due to the effect of the associate having applied the equity method to determine the carrying amount of its investment in the investor being included in the associate's increase in net assets.

5.41 Adjustments for cross-holdings should be made using the treasury stock method. The treasury stock method is based on the view that entities involved in cross-holdings acquire the equivalent of a direct interest in their own net assets. Application of the treasury stock method ensures that multiple counting of net

surplus and net assets does not arise. Guidance on the treasury stock method can be found in R-116: *Accounting for Companies Involved in Cross Holdings*.

Carrying Amount of the Investment in an Associate

STANDARD

5.42 If, and only if, the recoverable amount of an investment in an associate is less than its carrying amount, the carrying amount of the investment must be written down to its recoverable amount. The write-down to recoverable amount must be recognised in the statement of financial performance.

5.43 The carrying amount of an investment in an associate that has previously been written down to recoverable amount in accordance with paragraph 5.42 must be increased to its current recoverable amount if, and only if, there has been a change in the estimates used to determine the recoverable amount. The increased carrying amount of the investment must not exceed the carrying amount that would have been determined if the write-down to recoverable amount had not occurred. The reversal of a write-down to recoverable amount of an investment must be recognised in the statement of financial performance.

COMMENTARY

5.44 The carrying amount of an investment in an associate should not exceed its recoverable amount. A comparison of carrying amount and recoverable amount should therefore be made at each reporting date.

5.45 Where goodwill exists, this will be recognised as part of the carrying amount of an investment in an associate to the extent it has not been notionally amortised. Recognition of a write-down to recoverable amount may therefore include, or totally relate to, goodwill. Any reversal of a previous write-down to recoverable amount in accordance with paragraph 5.43 may therefore include, or totally relate to, a recovery of goodwill. However, the measurement, subsequent to acquisition, of goodwill is subject to uncertainty and a subsequent increase in the recoverable amount of goodwill is thus likely to be an increase in internally generated goodwill rather than purchased goodwill. Therefore, any write-down to recoverable amount should first be applied to the goodwill component until this is exhausted and any subsequent recovery of a previous write-down to recoverable amount should first be applied to the impaired investment carrying amount, excluding the goodwill component, until this is fully recovered. That is, under this treatment, goodwill is impaired first and recovered last.

STANDARD

5.46 Where the equity method is applied, the maximum amount at which an investment in an associate can be recognised is the carrying amount determined by applying the equity method.

COMMENTARY

5.47 Application of the equity method of accounting precludes the recognition of increases in the carrying amount of the investment through revaluations. This prevents a combination of equity accounting and market value accounting from being applied with regard to the same investment.

Changes in Investor's Ownership Interest

STANDARD

5.48 Where the equity method is applied and the investor's ownership interest in an associate is decreased:

(a) the carrying amount of the investment in the associate must be adjusted to reflect the decrease in ownership interest;

(b) any loss or gain on the decrease in ownership interest must be recognised in the statement of financial performance; and

(c) the component of the investor's equity arising from recognition of the investor's share of the associate's post-acquisition revenues and expenses must be adjusted to reflect the decrease in ownership interest and reclassified in the investor's equity.

5.49 Where the equity method is applied and the investor's ownership interest in an associate is increased:

(a) the carrying amount of the investment in the associate must be increased by any cost of acquisition of the increase in ownership interest; and

(b) the equity method must be applied, with reference to the date the increase in ownership interest is obtained, as follows:

- **(i) up until that date based on the ownership interest held prior to that date; and**
- **(ii) subsequent to that date based on the increased level of ownership interest held from that date.**

COMMENTARY

5.50 The investor's proportionate ownership interest in an associate may change due to a sale of part of that interest or a purchase of a further interest by the investor, or as a result of some other circumstance such as a further issue or repurchase of its equity by the associate involving parties other than the investor. Where a decrease occurs, adjustments should be made to both the carrying amount of the investment and the component of the investor's equity that relates to the share of the associate's net assets. These adjustments are illustrated in Appendix 5 to this Standard. Where an increase occurs, the carrying amount of the investment is increased by any cost of purchase, and the equity method is applied in accordance with the respective levels of ownership held during the period.

Discontinuation of the Equity Method

STANDARD

5.51 The equity method must be discontinued when an investee ceases to qualify as an associate because the investor's influence over the investee has been reduced. Thereafter, where the investment is retained, it must be accounted for as an investment other than an investment in an associate. In these circumstances, the carrying amount of the investment, as determined by the equity method, remains the carrying amount of the investment, subject to adjustment, determined in accordance with paragraph 5.48, to reflect any decrease in ownership interest. Subsequent distributions from the investee must be recognised as revenue to the extent that they are not already recognised in the carrying amount of the investment.

COMMENTARY

5.52 For the purposes of determining whether subsequent distributions from the investee are already recognised in the carrying amount of the investment, distributions should be deemed to have been paid or be payable out of surpluses prior to the date when application of the equity method was discontinued if the aggregate of those distributions exceeds the investor's share of accumulated total recognised revenues and expenses (adjusted for items at paragraph 5.23) of the investee for the accounting periods subsequent to that date.

STANDARD

5.53 Where the equity method is applied and the investor's share of the post-acquisition reductions in net assets of an associate exceeds the cost of the investment less any amounts written off, so that the investment is reduced to zero, the investor must discontinue applying the equity method and must not recognise as a liability any balance below zero. If the net assets of the associate subsequently increase, the investor must resume applying the equity method only after its share of such increase in net assets equals its share of any reduction in net assets not recognised during the period the equity method was suspended.

COMMENTARY

5.54 The investment in the associate is the reporting entity's share in the net assets of the associate together with any other balances that are in effect equity. Circumstances may arise where the investor's investment in the associate involves long-term indebtedness rather than funding solely by way of equity. The indebtedness is frequently permanent in nature, and there may or may not be interest flows attached to that indebtedness. Permanent funding, even though structured as debt, should be treated as equity for the purposes of equity accounting.

5.55 Paragraph 5.53 prohibits the recognition of any balance below zero in applying the equity method. However, where the investor has guaranteed the obligations of the associate or is otherwise committed to providing financial support, such guarantees and commitments should be recognised or disclosed, as appropriate, in accordance with the requirements of other financial reporting standards or generally accepted accounting practice. For example, any obligation of the investor concerning a guarantee over obligations of an associate will need to be recognised as a provision or, unless the possibility of sacrifice arising from such obligation is remote, disclosed as a contingent liability, in accordance with FRS-15: *Provisions, Contingent Liabilities and Contingent Assets.*

6 DISCLOSURES

STANDARD

6.1 The disclosure requirements in this section of the Standard apply to the financial statements of the investor that include application of the equity method, unless the requirement specifically refers to the investor's own financial statements.

6.2 The following information in respect of each significant associate must be disclosed in the investor's own financial statements:

(a) the associate's legal name, country of incorporation where other than New Zealand and principal activities;

(b) the reporting date, if different from that of the investor;

(c) the investor's ownership interest, if any, as at the associate's reporting date, and at the investor's reporting date (if different);

(d) the proportion of voting power held in the associate, if different from the ownership interest held;

(e) the carrying amount of the investment in the associate;

(f) the amount of any interest in the net assets of the investor held by the associate; and

(g) the fact that the associate's financial statements reporting date changed from that used in applying the equity method in previous years, and the effect of the change on the investor's financial statements, if appropriate.

COMMENTARY

6.3 Where a difference exists between reporting dates, it may also be necessary to include additional information in the investor's financial statements by way of note. This note would disclose significant events or transactions which have occurred since the date of the associate's previous financial statements where these events or transactions could materially affect the performance or financial position of the associate for the subsequent accounting period.

6.4 For the purposes of the application of paragraph 6.2, a significant associate is an associate that is material to the entity reporting in terms of either size or nature. The entity reporting will be the group where the associate is equity accounted in the group financial statements and the investor where the associate is equity accounted in either the investor's financial statements or a separate set of financial statements.

6.5 In assessing significance based on size, consideration should be given to the proportion of the recognised or unrecognised financial elements of the associate to the corresponding financial elements of the entity reporting. This assessment should include consideration of the impact on the entity reporting of any potential transaction or event that may arise in the course of the associate's activities.

6.6 In assessing significance based on nature, consideration should be given to how much the activities undertaken by the associate differ from those undertaken by the entity reporting. The greater the difference, the more likely it is that an associate will be significant based on nature. In many cases, details of an associate that undertakes different activities from the entity reporting will be of high information value when the associate is not significant based on size, because relevant information may then be excluded from the segment disclosures of the entity reporting.

STANDARD

6.7 Disclosure must be given, on an aggregate basis, of the investor's share of its associates':

(a) contingent assets and contingent liabilities; and

(b) amounts committed for future capital expenditure.

6.8 Disclosure must be given, in the investor's own financial statements, of the aggregate amount of all liabilities of associates for which the investor is jointly and severally liable.

6.9 Where the equity method is applied to investments in associates, the following information must be disclosed on an aggregate basis:

(a) the amount of the investor's share of the associates':

- **(i) operating surpluses or deficits;**
- **(ii) tax expense attributable to operating surpluses or deficits;**
- **(iii) extraordinary items; and**
- **(iv) total recognised revenues and expenses other than net surpluses or deficits;**

(b) the movements in the carrying amount of investments in associates, separately identifying the carrying amount as at the beginning and end of the period, the amounts of new investments, disposals, share of total recognised revenues and expenses, dividends, and other movements;

(c) the amount of goodwill included in the carrying amount of investments in associates as at the beginning and end of the period;

(d) the financial effects of events or transactions which have occurred after the reporting date of an associate and which could materially affect the financial position or operating performance of that associate for the subsequent accounting period;

(e) where adjustments to eliminate the effect of different accounting policies cannot be made, the nature of the differences;

(f) the gross amount of goodwill and the accumulated amortisation of goodwill (including accumulated impairment write-downs net of any reinstated amounts) at the end of the period;

(g) the amount of any goodwill or other asset written down due to impairment in the current period; and

(h) the amount of any goodwill or other asset written down due to impairment in a previous period that has been reinstated during the current period.

COMMENTARY

6.10 Disclosure of the nature of any unadjusted differences in accounting policies used is meaningful where it is supplemented by information as to the proportions of assets and liabilities to which different accounting policies have been applied with regard to the assets and liabilities of all associates.

STANDARD

6.11 The following information must be separately disclosed:

(a) the legal name of any entity that became an associate during the reporting period, and the corresponding date;

(b) the legal name of any entity that ceased to be an associate during the reporting period, and the corresponding date;

(c) the legal name of any associate in which, at the investor's reporting date, the ownership interest attributable to the investor is less than 20 per cent, together with an explanation of how significant influence exists; and

(d) the legal name of any entity in which, at the investor's reporting date, the ownership interest attributable to the investor is 20 per cent or more but which is not an associate of that investor, together with an explanation of why significant influence does not exist.

7 TRANSITIONAL PROVISIONS

STANDARD

7.1 Comparative figures are not required to be presented in the first period of application of this Standard with regard to items required under this

Standard that have not been disclosed in the entity's general purpose financial statements of the prior period.

COMMENTARY

7.2 The disclosure of comparative figures that are not required as a consequence of paragraph 7.1 is encouraged.

STANDARD

7.3 Subject to paragraph 7.5, where an associate of the investor at the beginning of the period to which this Standard is first applied has been previously accounted for under the equity method of accounting, the carrying amount of the investment at the end of the period immediately prior to that to which this Standard is first applied is deemed to have been determined in accordance with this Standard.

7.4 Where an associate of the investor at the beginning of the period to which this Standard is first applied has not been previously accounted for under the equity method of accounting up to this time, the carrying amount of the investment must be adjusted to the amount that would have been the carrying amount at the end of the period immediately prior to that to which this Standard is first applied had the requirements of this Standard been applicable from the acquisition date of the investment. The amount of this adjustment must be recognised in the statement of movements in equity as an adjustment against equity at the beginning of the period to which this Standard is first applied, and relevant portions of this amount must be included in any components of equity that are separately disclosed.

7.5 Where, at the beginning of the period to which this Standard is first applied, goodwill attributable to associates is separately recognised, such goodwill must be reclassified as part of the carrying amount of investments in associates.

COMMENTARY

7.6 This Standard requires goodwill attributable to the acquisition of an associate to be recognised as part of the carrying amount of the investment and not separately recognised. This differs from the position in the predecessor standard to this Standard which required such goodwill to be recognised as a separate asset. This Standard therefore requires any remaining such goodwill to be transferred to the investment carrying amount for prospective presentation.

7.7 Any goodwill included in the carrying amount of an investment in an associate covered by paragraphs 7.3 and 7.4 is to be notionally amortised over its remaining useful life as determined in accordance with this Standard.

APPENDIX 1

Comparison of FRS-38 with International and Australian Accounting Standards

This comparison appendix was prepared as at 20 August 2001 and deals only with significant differences between the standards. The comparison is produced for information purposes only and does not form part of the standards in FRS-38.

Accounting standards are promulgated internationally by both the International Accounting Standards Board (IASB) and the Public Sector Committee of the International Federation of Accountants (IFAC PSC).

The International and Australian accounting standards comparable with FRS-38 are:

IASB

- IAS 28 (revised 2000): *Accounting for Investments in Associates*.

IFAC PSC

- IPSAS-7 (2000): *Accounting for Investments in Associates*;

AUSTRALIA

- AASB 1016 (1997): *Accounting for Investments in Associates*;
- AAS 14 (1997): *Accounting for Investments in Associates*.

The requirements of AAS 14 are identical to those of AASB 1016 other than with regard to minor differences in scope and terminology. In this appendix, a reference to a requirement of AASB 1016 should be interpreted as a reference to a requirement of AAS 14 also.

There is substantial agreement among these standards and FRS-38. The following summarises the significant differences between FRS-38, AASB 1016, IAS 28, and IPSAS-7.

Treatment in Separate Financial Statements of the Investor

AASB 1016, IAS-28, IPSAS-7 and FRS-38 all require the equity method to be applied in the consolidated financial statements of the investor. However, differences exist amongst the three standards with regard to the treatment requirements in the separate financial statements of the investor.

AASB 1016 requires the cost method to be applied in the investor’s own financial statements, except where consolidated financial statements are not prepared, in which case the equity method is to be applied. AS 28 allows either the equity method or the cost method to be applied in the investor’s own financial statements. IPSAS-7 requires either the equity method or the cost method to be applied in the investor’s own financial statements, according to which method is used in the

consolidated financial statements, or which method would be required to be used if consolidated financial statements were prepared. FRS-38 provides that where an investor does not have subsidiaries, the investor must apply the equity method in either its own financial statements or in a separate set of financial statements that are in addition to its own financial statements.

Impairment

Both AASB 1016 and FRS-38 require a write-down whenever the recoverable amount of the investment in an associate falls below its carrying amount. IAS-28 and IPSAS-7 both refer to standards covering impairment. For IAS 28, this involves application of IAS 36: *Impairment of Assets*, which is consistent with the requirements in AASB 1016 (subject to the differences below) and FRS-38. For IPSAS-7, this involves application of other relevant national or international standards.

AASB 1016 defines recoverable amount as the expected amount to be recovered through continued use and subsequent disposal of the asset. In contrast, FRS-38, and by extension IAS 28, define recoverable amount as the greater of net market value and value-in-use, with different measurements corresponding to the two separate components. However, the practical effect of the difference between AASB 1016 and FRS-38/IAS 28 in definition of recoverable amount is unlikely to be significant.

The reinstatement provisions contained in FRS-38 are consistent with IAS-36 which permits the reversal of a write-down for impairment only to the extent that there has been a change in the estimates used to determine the amount of the write-down. This differs from AASB 1016, which does not restrict the reversal of impairment write-downs to specific circumstances.

Definition of Associate

AASB 1016 includes in its definition of associate the requirement that the investment not be acquired and held exclusively with a view to disposal in the near future. IAS 28, IPSAS-7, and FRS-38 do not limit the definition of associate with this requirement. However, a similar result is still achieved between the four standards since IAS 28, IPSAS-7, and FRS-38 exclude such temporarily held associates in establishing the requirement to apply the equity method.

IAS 28 and IPSAS-7 also preclude an associate which operates under long-term restrictions that significantly impair its ability to transfer funds to the investor, from being accounted for under the equity method. Such circumstances are raised as a presumption that significant influence does not apply under both AASB 1016 and FRS-38.

Relationship Between Equity and Market Value Accounting

In financial statements subject to the equity method, both AASB 1016 and FRS-38 prohibit the application of market value accounting to associates instead of the equity method except when the ability to apply market value accounting to associates is expressly permitted or required under another accounting standard. IAS 28 and IPSAS-7 do not consider the relationship between application of the equity method and market value accounting to associates in the investor's consolidated financial statements. However, both IAS-28 and IPSAS-7 permit associates to be accounted for as investments in the investor's own financial statements as an alternative to the equity method or the cost method.

Extent of Guidance in Application of the Equity Method

Both AASB 1016 and FRS-38 include extensive guidance with regard to the application of the equity method whereas guidance in IAS 28 and IPSAS-7 is limited. Additional guidance in FRS-38 that is not contained in the other standards covers:

- situations of inability to determine fair values; and
- the specific approach to deal with cross-holdings.

Disclosures

IAS 28 and IPSAS-7 require limited disclosures concerning investments in associates. In contrast, both AASB 1016 and FRS-38 require extensive levels of disclosure. Additional disclosures required by AASB 1016 and FRS-38 include details of associates' capital commitments, cross-holdings, certain components of changes in associates' net assets, movements in carrying amounts, and any differences in investor and associate reporting dates and accounting policies.

APPENDIX 2

Investee Becoming an Associate Subsequent to Initial Acquisition

The content of this appendix is included for illustrative purposes only and does not form part of the Financial Reporting Standard.

This appendix illustrates the adjustment required under FRS-38, paragraph 5.11, when an investee becomes an associate subsequent to the initial acquisition of an ownership interest by the investor.

An investor acquired a ten percent interest in an investee on 1 January X1 for $76,000. As at this date the fair value of the net assets of the investee was $700,000 and comprised contributed capital of $500,000, asset revaluation reserve of $100,000 (arising from revaluation made as at 31 December X0) and retained net surpluses of $100,000. A further fifteen percent interest was acquired on 31 December X3 for $168,000. Significant influence is achieved on 31 December X3. At this date the fair value of the net assets of the investee was $920,000 and comprised contributed capital $500,000, asset revaluation reserve $200,000 and retained net surpluses $220,000.

The investor had applied the cost method to account for its investment made at 1 January X1. The investor's accounting policy is to amortise goodwill over the period of benefit, which in this case is three years.

The investee, which had revalued its non-current assets as at 31 December X2, reported net surpluses of $80,000, $60,000, and $100,000 in the years ended December X1, X2 and X3. Dividends from post-acquisition net surpluses received by the investor were $4,000 in each year.

FRS-38, paragraph 5.11, requires:

(a) **the carrying amount of the investment must be adjusted to that amount which would have been the carrying amount had it been an investment in an associate since the initial acquisition date;**

(b) **the amount of the adjustment made to reflect the share of net surpluses or deficits of the associate since the initial acquisition date must be recognised in the statement of financial performance; and**

(c) **the amount of the adjustment made to reflect any other movements in equity of the associate since the initial acquisition date must be recognised in the statement of movements in equity.**

The amount of the adjustment to the carrying amount of the investment made at 31 December X3 would be determined as follows:

(a) Acquisition of 10% interest: 1 January X1

Consideration paid	\$76,000
Share of net assets acquired	\$70,000
Goodwill	\$6,000

(b) Acquisition of 15% interest: 31 December X3

Consideration paid	\$168,000
Share of net assets acquired	\$138,000
Goodwill	\$30,000

At 31 December X3 the carrying amount of the investment in the financial statements of the investor would be \$244,000 (\$76,000 + \$168,000) under the cost method. For the purposes of accounting in the consolidated financial statements, or in additional financial statements of the investor if it is not a parent, the carrying amount would be adjusted as follows:

	Debit	*Credit*
Investment	16,000	
Operating Revenue		6,000
Asset Revaluation Reserve		10,000

The change in the carrying amount of the investment arises from:

(a)	restating recognised revenues as an adjustment to investments in associates Dividends received or receivable	(12,000)
(b)	recognition of the share of net surpluses post-acquisition of tranche 1, now to be equity accounted \$240,000 × 10%	24,000
	Less: adjustments to reflect amortisation of goodwill since acquisition \$2,000 per year for 3 years	(6,000)
	Net adjustment to statement of financial performance	6,000

(c)	recognition of the share of movement in asset revaluation reserve occurring post-acquisition of tranche 1, now to be equity accounted $100,000 × 10%	10,000
	Total increase in the equity accounted carrying amount of the investment	$16,000

APPENDIX 3

Change From Market Value Accounting to Equity Accounting

The content of this appendix is included for illustrative purposes only and does not form part of the Financial Reporting Standard.

This appendix illustrates the adjustment and disclosure required where an investee has become an associate subsequent to the initial acquisition of an ownership interest by the investor in circumstances where the initial ownership interest has been accounted by the investor on a market value basis.

Following are the statement of financial positions and share prices of Investee Ltd at various dates. All assets and liabilities are recognised at fair values.

	1/4/X0	31/3/X1	31/3/X2
Equity			
– contributed capital (100 shares issued @ $2)	200	200	200
– retained earnings	100	140	200
– revaluation reserve	100	160	200
	400	500	600
Assets	1000	1200	1400
Liabilities	(600)	(700)	(800)
	400	500	600
Share price	$4.50	$5.20	$6.40

Investor Ltd purchases 10% of the shares in Investee Ltd on 1/4/X0 (at $4.50 each) for $45 and purchases a further 30% of the shares in Investee Ltd on 31/3/X2 (at $6.40 each) for $192.

Assume the following:

- Investor Ltd's balance date is 31/3.
- Investor Ltd accounted for its investment in Investee Ltd at market value in Investor Ltd's 31/3/X1 financial statements — revaluation increment was $7 (10 shares @ ($5.20 – $4.50)).
- The useful life of any purchased goodwill in Investee Ltd is five years.
- Investee Ltd became an associate of Investor Ltd from 31/3/X2 as a result of Investor Ltd holding a 40% interest in Investee Ltd.

Under FRS-38, Investor Ltd is required to equity account its investment in 7Investee Ltd in its 31/3/X2 financial statements. An adjustment will therefore be required in Investor Ltd's 31/3/X2 financial statements to incorporate the effect of the step acquisition in accordance with FRS-38, paragraph 5.11 (see example in Appendix 2). However, this adjustment will need to be modified to take account of the effect of the recognition by Investor Ltd of its 10% interest in Investee Ltd at market value in the 31/3/X1 year. The following workings show how the required entry in the 31/3/X2 financial statements of Investor Ltd may be arrived at.

Position in Investor Ltd's financial statements at 1/4/X2 prior to adjustment:

Investment in Investee Ltd (asset) (45 + 7 + 192)	244 Dr
Investment revaluation reserve (equity)	7 Cr

Calculation of adjustment under paragraph 5.11 at 31/3/X2 assuming 10% investment carried at cost:

	Equity at acquisition of 10% interest 1/4/X0	Equity at acquisition of 30% interest 31/3/X2	Movement from 1/4/X0 to 31/3/X2	10% share of movement	Notional amortisation of goodwill (2 years)	Recognised movement
Investee Ltd Equity						
– contributed capital	200	200	–	–	–	–
– retained earnings	100	200	100	10	(2)[1]	8
– revaluation reserve	100	200	100	10	–	10

1 Calculation of notional goodwill (and annual amortisation) on the 10% acquisition is:

Fair value of equity	400
% of fair value	40
Cost of acquisition	45
Notional goodwill	5
Annual amortisation (five year life)	1

Calculation of adjustment required at 31/3/X2:

Investor Ltd financial statements (amounts relating to Investee Ltd)	Position at 31/3/X2 after paragraph 5.11 adjustment assuming no market value accounting of 10% investment	Actual position at 31/3/X2 (market value accounting of 10% investment at 31/3/X1)	Adjustment required at 31/3/X2
Equity			
– retained earnings	8	–	8
– asset revaluation reserve	10	–	10
– investment revaluation reserve	–	7	(7)
Assets			
Investment in Investee Ltd	255	244	11

Journal entry by Investor:

	Debit	*Credit*
	$	$
Investment Revaluation Reserve	7,000	
Investment in Associate		7,000

Notional journal entry:

	Debit	*Credit*
	$	$
Investment	18,000	
Retained Earnings		8,000
Investment Revaluation Reserve		10,000

Disclosure in Investor Ltd's financial statements at 31/3/X2:

Statement of Financial Position

Non-current assets – Investment in Investee Ltd (see note)	255
Equity – included in retained earnings	8
– included in asset revaluation reserve	10

Statement of Movements in Equity

Total recognised revenues and expenses – share of Investee Ltd asset Revaluation reserve for period 1/4/X0 to 31/3/X2 (see note)	3

Statement of Financial Performance

Operating revenue – share of Investee Ltd net surplus for period 1/4/X0 to 31/3/X2 (see note)	8

Note

At 31/3/X2, Investor Ltd had a 40% holding in associate Investee Ltd which is required, by FRS-38: *Accounting for Investments in Associates*, to be accounted for under the equity method of accounting. 30% was acquired on 31/3/X2 for $192. In the 31/3/X1 year, Investor Ltd recognised its 10% investment at market value with the movement in market value recognised in an investment revaluation reserve. The 30% acquisition necessitates an adjustment to equity account the 10% holding for the 31/3/X1 and 31/3/X2 years. Amounts recognised in Investor Ltd's statement of financial performance and statement of movements in equity during the 31/3/X2 period incorporate a reversal of the 31/3/X1 investment revaluation movement arising from Investor Ltd's previous policy to account for its 10% investment at market value.

Details of amounts recognised are:

Amounts recognised relating to Investee Ltd's surplus from 1/4/X0–31/3/X2	8
Amounts recognised relating to movements in Investee Ltd's asset revaluation reserve from 1/4/X0-31/3/X2	10
Adjustment for amounts recognised in investment revaluation reserve from 1/4/X0–31/3/X2	(7)
	11

APPENDIX 4

Inter-Entity Transactions

The content of this appendix is included for illustrative purposes only and does not form part of the Financial Reporting Standard.

This appendix illustrates the adjustment required to eliminate unrealised gains or losses arising on transactions between an investor and its investee in accordance with FRS-38, paragraph 5.35, as explained in paragraph 5.36.

Investor has a 40% interest in an associate. The associate's current year net surplus is $10,000. There are no other movements in the associate's equity and there are no fair value or goodwill amortisation adjustments to be made in determining the investor's share of the associate's post-acquisition movement in equity for the period.

During the current year goods having a cost price of $800 were sold for $2,000 between the investor and the associate. None of these goods had been resold at balance date.

FRS-38, paragraph 5.36 states:

> Where an unrealised gain or loss exists in the associate's financial statements as a consequence of a transaction between the associate and the investor or subsidiary of the investor, 100% of the attributable gain or loss should be eliminated before calculation of the investor's share of the associate's net surplus or deficit. Where an unrealised gain or loss exists in the financial statements of the investor or subsidiary of the investor, a percentage of the gain or loss equal to the investor's ownership interest in the associate should be eliminated.

The guidance in paragraph 5.36 may be illustrated using the above example as follows.

Situation 1 – Sale from associate to investor

Assume the sale of the goods is from the associate to the investor (up-stream sale). Given that all $1,200 profit on the sale is unrealised in the associate's financial statements, the entry to record the investor's share of the associate's net surplus will incorporate the adjustment to eliminate the unrealised profit included in the associate's net surplus of $10,000. The entry is as follows:

Journal entry by Investor:

	Debit	Credit
Dr Investment in associate	3,520	
Cr Operating revenue (statement of financial performance)		3,520

(Calculation is 40% x (10,000 – 1,200) = 3,520)

Situation 2 – Sale from investor to associate

Assume the sale of the goods is from the investor to the associate (down-stream sale). Given that all $1,200 profit on the sale is unrealised in the investor's financial statements, the entry to record the investor's share of the associate's net surplus will be unaffected by the unrealised profit. However, an additional entry will be necessary to remove the effects of the unrealised profit from the investor's earnings included in the group financial statements. However, the unrealised profit adjustment is limited to the investor's ownership interest in the associate. The entries are as follows:

Journal entries by Investor:

	Debit	Credit
Dr Investment in associate	4,000	
Cr Operating revenue (statement of financial performance)		4,000
(Calculation is 40% x 10,000 = 4,000)		
Dr Operating surplus ((statement of financial performance))	480	
Cr Investment in associate		480
(Calculation is 40% x 1,200 = 480)		

The limitation of the unrealised profit adjustment to the investor's ownership interest in the associate ensures that the same elimination from group earnings arises whether the sale is up-stream or down-stream. Thus, the net earnings included in group earnings for the period and the investment carrying amount are the same in situations 1 and 2. The difference in treatment concerns the calculation of the equity earnings.

APPENDIX 5

Decrease In Ownership Interest

The content of this appendix is included for illustrative purposes only and does not form part of the Financial Reporting Standard.

This appendix illustrates the adjustment required under FRS-38, paragraph 5.48, when the investor's ownership interest in an associate is reduced.

Investor Ltd holds a 40% interest in Investee Ltd and Investee Ltd is an associate of Investor Ltd. Investor Ltd purchased its 40% interest on 1/4/X0 and has accounted for its investment using the equity method in accordance with FRS-38. Following is the position regarding its investment in Investee Ltd in Investor Ltd's financial statements at 31/3/X3:

Statement of Financial Position of Investor Limited and its Associate

Non-current assets – Investment in Investee Ltd	300
Equity – included in retained earnings	40
– included in asset revaluation reserve	30

Assume purchased goodwill included in the cost of acquisition of the 40% holding was $20 and the useful life of the purchased goodwill is five years.

On 1/4/X3, Investor Ltd sold half its 40% holding in Investee Ltd for $160 cash.

FRS-38, paragraph 5.48, requires:

(a) an adjustment to the carrying amount of the investment to reflect the proportionate reduction;

(b) recognition in the statement of financial performance of any loss or gain on disposal; and

(c) a reclassification in equity of the attributable portion of the share of the associate's equity.

The adjustments required on 1/4/X3 in accordance with paragraph 5.48 are therefore:

	Debit	Credit
Bank	160	
Investment in Investee Ltd (half of $300)		150
Gain on disposal (Statement of financial performance) ($160-$150)		10

(to record the reduction in the carrying amount of the investment and the gain arising from the disposal of the 20% holding, in accordance with FRS-38, paragraph 5.48(a) and (b)).

	Debit	Credit
Retained earnings (attributable to associate) (half of $40)	20	
Asset revaluation reserve (attributable to associate) (half of $30)	15	
Retained earnings (attributable to investor)		35

(to record the reclassification in the Investor's equity of the previously recognised share of the associate's equity attributable to the disposal of the 20% holding, in accordance with FRS-38, paragraph 5.48(c)).

After the above adjustments, the carrying amount of Investor Ltd's investment in Investee Ltd is $150. This amount includes a notional (unamortised) goodwill component of $4 [50% × (20 - 3 × 4)]. Treatments in Investor Ltd's 31/3/X4 financial statements (assuming no other acquisitions or disposals) will then be:

If Investee Ltd remains an associate

If Investee Ltd remains an associate of Investor Ltd after the disposal of the 20% holding, Investor Ltd will equity account its 20% share of the movement in Investee's equity from 1/4/X3 – 31/3/X4. Recognition of Investor Ltd's 20% share of Investee Ltd's net surplus as operating revenue in Investor Ltd's statement of financial performance will be adjusted for the notional amortisation of goodwill of $2.

If Investee Ltd does not remain an associate

If Investee Ltd is no longer an associate of Investor Ltd after the disposal of the 20% holding, Investor Ltd will account for its remaining 20% holding as a simple investment. In accordance with paragraph 5.51, the carrying amount after the adjustment at 1/4/X4 (pursuant to paragraph 5.48) remains the carrying amount of the investment. The investment may then subsequently be accounted for either at cost or at market value. If the investment is accounted for at market value, at 31/3/X4 the carrying amount will be revalued and the revaluation movement recognised in an investment revaluation reserve through the statement of movements in equity.

HISTORY

Previously issued accounting standards superseded by this Financial Reporting Standard:

SSAP-8: *Accounting for Business Combinations* (revised October 1990 and effective for periods commencing on or after 1 January 1991).

SSAP-8: *Accounting for Business Combinations* (issued October 1987 and effective for periods commencing on or after 1 January 1988).

SSAP-2: *Accounting for Associated Companies* (Equity Accounting) (issued December 1974 and effective for periods commencing on or after 1 April 1975).

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