

Investments in associates (Lecture A642 – 15.39 minutes)

FRS 102 deals with investments in associates in Section 14 *Investments in Associates*. An ‘associate’ is defined in the Glossary to FRS 102 as:

*‘An entity, including an unincorporated entity such as a partnership, over which the investor has **significant influence** and that is neither a **subsidiary** nor an interest in a **joint venture**.’*

FRS 102 Glossary
associate

It is important to distinguish between an associate and a subsidiary because a parent-subsidiary relationship is created when the parent acquires **control** over the subsidiary. In such cases, group accounts may be required if any exceptions or exemptions from preparing group accounts cannot be claimed.

An investor has an investment in an associate when the investor has **significant influence** over the associate. The term ‘significant influence’ is defined as follows:

*‘Significant influence is the power to participate in the financial and operating policy decisions of the **associate** but is not **control** or **joint control**.’*

FRS 102 Glossary
significant influence

FRS 102, para 14.3 then goes on to provide additional guidance as follows:

- ‘(a) If an investor holds, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the associate, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case.
- (b) Conversely, if the investor holds, directly or indirectly (eg through subsidiaries), less than 20 per cent of the voting power of the associate, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated.
- (c) A substantial or majority ownership by another investor does not preclude an investor from having significant influence.’

FRS 102 para 14.3

Ownership interest of more than 20% but entity is not treated as an associate

Paragraph 14.3(a) of FRS 102 states an investor that holds, directly or indirectly, 20% or more of the voting power of the associate has significant influence, unless it can be clearly demonstrated that this is not the case.

The following are non-exhaustive examples of what may give rise to an ownership interest of 20% or more not being accounted for as an associate:

- Severe long-term restrictions prevent the investor from receiving funds from the investee.
- The investor rescinds all significant influence through an agreement with other investors.
- Law or regulation prevent significant influence from being exercised by the investor (for example in a foreign country).
- It is probable (ie more likely than not) that the investee will issue additional shares to third parties which dilute the ownership interest of the investor.

- There are adverse political and economic conditions in the foreign country which the investee is situated.

The above points are not exhaustive and it is important to scrutinise the substance of the relationship between the investor and the investee carefully because significant influence may be achieved by other means.

Ownership interest is less than 20% but entity is treated as an associate

Paragraph 14.3(b) of FRS 102 states that where an investor holds, directly or indirectly, less than 20% of the voting rights of an entity, it is presumed that significant influence does not exist unless such influence can be clearly demonstrated.

Significant influence with a holding of less than 20% of the voting rights of an entity could arise, for example, where the investor's major shareholder or parent holds additional shares in the investee or the investee is a member of the executive or finance committee.

Ceasing to have significant influence

Significant influence over an investee is lost when the investor loses the power to participate in the financial and operating policy decisions of the investee. The loss of significant influence usually occurs due to disposal of the investee but it can also occur where the entity is taken over as a matter of law (eg by a court or official receiver).

Once significant influence is lost, the use of the equity method of accounting must cease.

Measurement – investor is not a parent

Paragraph 14.4 of FRS 102 states that an investor who is not a parent, but has an investment in one, or more, associates shall, in its individual financial statements, account for all of its investments in associates using either:

- the cost model;
- the fair value model per paragraphs 14.9 to 14.10A of FRS 102; or
- at fair value through profit or loss.

The above accounting policy choices only apply to investors that are not parents – ie they do not own any subsidiaries.

An investor which is not a parent and which chooses to adopt the cost model measures its investments in associates at cost less accumulated impairment losses.

Dividends and other distributions which are received from the investment are recognised as income regardless of whether the distributions are received from accumulated profits of the associate arising before, or after, the date of acquisition.

Therefore, under the cost model:

- investments in associates are recognised at cost (including transaction costs such as legal fees);

- dividends and distributions are taken to the profit and loss account as income; and
- where there are indicators that the investment is impaired at the balance sheet date, it is written down to recoverable amount by way of an impairment loss. Impairment losses are recognised in profit and loss.

In practice, the cost model is the most common model used due to its simplicity.

Measurement – investor is a parent

Where the investor is a parent that prepares group accounts, they must, in their consolidated accounts, account for all of their investments in associates using the equity method of accounting (see 2.6 below). An exception to this rule would be where the associate is held as part of an investment portfolio as this would be measured at fair value through profit or loss in the group accounts.

The term ‘held as part of an investment portfolio’ is defined as follows:

*‘An interest is held as part of an investment portfolio if its value to the investor is through **fair value** as part of a directly or indirectly held basket of investments rather than as media through which the investor carries out **business**. A basket of investments is indirectly held if an investment fund holds a single investment in a second investment which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund is first being established and is expected to acquire additional investments.’*

FRS 102 Glossary **held as part of an investment portfolio**

Equity method of accounting

FRS 102, paragraph 14.8 states:

*‘Under the equity method of accounting, an equity investment is initially recognised at the transaction price (including **transaction costs**) and is subsequently adjusted to reflect the investor’s share of the profit or loss, **other comprehensive income** and **equity** of the associate.’*

FRS 102, para 14.8

Paragraph 14.8 refers to ‘equity investment’ but FRS 102 does not define this term. Equity instruments are usually investments in shares of another entity.

In the broadest terms, the equity method of accounting works as follows:

- initial recognition at cost; *plus* or (*minus*);
- share of profit (loss) from associate; *less*
- dividends and other distributions received from the associate.

Dividends and other distributions received from the associate are not taken to profit or loss under the equity accounting method; instead, they reduce the value of the investment in the consolidated balance sheet. A review of some financial statements has indicated that this accounting treatment has been incorrectly applied in the past, with some dividends and distributions being credited to the profit and loss account. This is incorrect under equity accounting as you are instead recognising a

proportion of the profit of the associate. If you also recognised the dividends, you would be double-counting the associate's contribution to the group's profit.

Example – Equity accounting

On 1 January 2018, Smith Ltd acquires a 35% interest in Jones Ltd for £475,000. On this date, the book value of Jones' assets were £900,000. During the year to 31 December 2018, Jones makes a profit of £80,000 and pays a dividend of £120,000. The transactions are accounted for under the equity method of accounting as follows:

Acquisition of Jones Ltd

	£	£
Share of Jones net assets (£900,000 x 35%)	315,000	
Goodwill arising (£475,000 less £315,000) ¹	<u>160,000</u>	
		475,000
Share of profit (£80,000 x 35%)		28,000
Dividend received (£120,000 x 35%)		<u>(42,000)</u>
Carrying amount in group accounts at 31 December 2018		<u>461,000</u>

Reconciled as:

Share in book value of Jones net assets	301,000
(£315,000 + 35% (£80,000 - £120,000))	
Goodwill	<u>160,000</u>
Carrying value per group accounts at 31 December 2018	<u>461,000</u>

Additional considerations for the equity method

As noted above, distributions received from the associate reduce the carrying value of the investment; they are not taken to profit or loss. Adjustments to the carrying amount of the investment may also be required due to changes in the associate's equity arising from items of other comprehensive income.

When the interest in the associate is reduced to zero, any further losses are only recognised to the extent that the investor has a legal or constructive obligation, or has made payments on behalf of the associate.

¹ Goodwill 'arises' on the acquisition of Jones Ltd but is not shown separately in the group accounts, it is subsumed within the carrying amount of the investment in associate. The example shows it separately to show how it is calculated.

FRS 102 does not provide guidance as to what happens in the event that dividends are received to the extent that the investment is reduced to zero and further dividends or distributions are then received. In such situations, provided that the distributions are not refundable by the investor and the investor is not liable for the investor's liabilities, then any dividends or distributions received in excess of the carrying value of the investment should be recognised in income. It would not be appropriate to have a negative balance as an investment in associate in the group's balance sheet.

Potential voting rights

While potential voting rights are brought into consideration when establishing whether significant influence exists, the investor must measure its share of profit or loss and other comprehensive income (and its share of changes in the associate's equity) on the basis of the actual ownership interest at the reporting date and these measurements must not reflect the potential exercise, or conversion, of potential voting rights (eg where the investor has provided convertible debt).

Implicit goodwill and fair value adjustments

On acquisition of an associate, goodwill is the difference between the cost of the acquisition and the investor's share of the fair value of the net identifiable assets of the associate (see the example above). The investor must adjust its share of the associate's profit or losses after acquisition so as to account for the additional depreciation or amortisation of the depreciable or amortisable assets in the associates. This is because, at the date of acquisition, the associate's identifiable asset and liabilities will be fair valued and the fair values may be different than book values at the time the associate is acquired giving rise to a fair value adjustment to be incorporated in the consolidated financial statements.

Impairment

Where there is evidence that an associate is impaired, the investor must test the entire carrying amount of the investment for impairment using the provisions in Section 27 of FRS 102 as appropriate. The test for impairment is as a single asset. Goodwill arising on the acquisition of an associate is **not** tested separately, but is part of the test for impairment on the entire investment.

Investor's transactions with associates

It is not uncommon for an investor to trade with its associates and vice versa. Where such trading takes place, the investor must eliminate all unrealised profits and losses in a two-way direction (ie 'upstream' which refers to trading between the associate and the investor, and 'downstream' which refers to trading between the investor and the associate). Care must be taken here because this is not the same as eliminating intra-group trading where a subsidiary is concerned. This is because, in the case of an associate, the investor will only eliminate unrealised profits and losses to the extent of the investor's interest in the associate. In addition, it must be borne in mind that unrealised losses on such transactions may indicate that the asset transferred is impaired.

As associates are not part of an investor's group, any inter-company balances between the group and the associates are not eliminated as they are when a subsidiary is consolidated.

Normal trading balances which are unsettled at the balance sheet date are recognised as current assets or current liabilities as appropriate. In addition, any long-term loans to the associate are disclosed as due after more than one year and this will require consideration as to whether such balances are shown as fixed assets or debtors due after more than one year in the consolidated balance sheet.

Coterminous period end

The equity method of accounting requires the associate to use the same accounting reference date as that of its investor, unless this is impracticable to do so. Such impracticalities are likely to be rare, but where it does prove to be impracticable the investor should use the most recent available financial statements of the associate and make adjustments for the effects of any significant transactions or events that have taken place between the two accounting periods.

Accounting policies

Where the associate uses accounting policies which differ from those used by the investor, the investor must adjust the associate's financial statements so that they reflect the accounting policies for the purposes of applying the equity method, unless it is impracticable to do so. Again, it is likely to be rare for such impracticalities to exist in practice.

Losses in excess of the investment

As noted above, when the investor's interest is zero, any additional losses are recognised as a provision but only to the extent that the investor has incurred a legal or constructive obligation which will necessitate the recognition of a provision under which the requirements of Section 21 *Provisions and Contingencies* of FRS 102 will be applied. In addition, the investor may also recognise a provision where it has made payments on behalf of the associate.

When the associate subsequently reports a profit, the investor can then resume recognising its share of those profits, but only where its share of the profits is equivalent to the share of losses not recognised.

Discontinuing the equity method

Generally, the equity method of accounting ceases from the date that the investor no longer has significant influence over the investment. The equity method will also no longer apply where the investor becomes a subsidiary (ie the investor increases its ownership interest in the associate such that a parent-subsidiary relationship is created, usually by way of an ownership interest of 51% or more). Where control is achieved, the investor applies the provisions in Section 19 *Business Combinations and Goodwill*.

Conversely, if the associate becomes a joint venture, the investor will also cease to use the equity method (except in the case of a jointly controlled entity in the consolidated financial statements) and accounts for the joint venture in accordance with Section 15 of FRS 102.

Where the equity method of accounting is discontinued, the accounting for such is as follows:

- Where significant influence is lost as a result of a full or partial disposal, the associate is derecognised from the balance sheet and the difference between the disposal proceeds and the carrying amount of the investment at the date of disposal is recognised in profit or loss. Any interest which the investor continues to retain following the disposal is accounted for using Section 11 or Section 12 of FRS 102 as appropriate. The carrying amount of the associate on the date of disposal is then regarded as cost on initial measurement of the financial asset.
- If other reasons apply for the loss of significant influence, other than a partial disposal of the investment, the investor regards the carrying value of the investment as at that date as the new cost and the investment is accounted for under Section 11 or Section 12 of FRS 102 as appropriate.

The gain or loss recognised on disposal should also include all amounts that have been recognised in other comprehensive income which relate to the associate subject to the disposal and where such amounts have to be reclassified to profit or loss on disposal. Where amounts cannot be recycled through profit or loss, they are transferred directly to retained earnings.

In practice, the only items which may need to be reclassified on disposal of an associate under FRS 102 are those amounts relating to cash flow hedges that had been recognised in other comprehensive income.

Fair value models

Investors that are not parents but have an investment in one, or more, associates have an accounting policy option available to them which allows them to measure their investments in associates at fair value in the individual financial statements. Both the cost model, and the fair value model, are not alternatives for equity accounting in the group accounts as they are only relevant to the individual financial statements of the investor.

Initial recognition

On initial recognition, the investment in associate in the financial statements of an investor that is not a parent which chooses to adopt the fair value model shall measure it at transaction price. Any transaction costs which are incurred in acquiring the associate are immediately expensed; they are not recognised on the balance sheet as part of the cost of the associate.

Subsequent measurement

At each balance sheet date, an investor that is not a parent which chooses to adopt the fair value model for its investments in associates shall measure its investments in associates at fair value. Changes in fair value from the previous reporting date are recognised in other comprehensive income.

Paragraph 14.10 of FRS 102 was amended as part of the triennial review. An investor measuring an investment in an associate at fair value is required to use the fair value guidance which is in paragraphs 11.27 to 11.32 of the September 2015 edition of FRS 102. This fair value guidance was moved as part of the triennial review's amendments into the Appendix to Section 2 *Concepts and*

Pervasive Principles and paragraph 14.10 was amended in this respect. In addition, the undue cost or effort exemption was removed.

Dividends and distributions

Where the fair value model is being used to measure investments in associates, any dividends or distributions received from the associate are recognised as income in profit or loss regardless of whether the distributions are from accumulated profits of the associate which arose before or after the date of acquisition.

Fair value through profit or loss

As an accounting policy choice, paragraph 14.4 of FRS 102 allows an investor to account for its investments in associates at fair value through profit or loss.

Under this model, fluctuations in fair value are taken to profit or loss, as are dividends and other distributions from the associate. Fair value is determined by the investor having regard to the relevant fair value guidance (paragraphs 11.27 to 11.32 of FRS 102 (September 2015) or the Appendix to Section 2 in the March 2018 edition of FRS 102).

Disclosure requirements (Companies Act 2006)

Schedule 4 *Information on related undertakings required whether preparing Companies Act or IAS accounts* at paragraph 19 requires the following disclosures in respect of associated undertakings:

- ‘(1) The following information must be given where an undertaking included in the consolidation has an interest in an associated undertaking: *Accounting Regulations, Sch 4, para 19*
- (2) The name of the associated undertaking must be stated.
- (3) There must be stated—
- (a) if the undertaking is incorporated outside the United Kingdom, the country in which it is incorporated,
 - (b) if it is unincorporated, the address of its principal place of business.
- (4) The following information must be given with respect to the shares of the undertaking held—
- (a) by the parent company, and
 - (b) by the group,
- and the information under paragraphs (a) and (b) must be shown separately.
- (5) There must be stated—

- (a) the identity of each class of shares held, and
 - (b) the proportion of the nominal value of the shares of that class represented by those shares.
- (6) In this paragraph “associated undertaking” has the meaning given by paragraph 19 of Schedule 6 to these Regulations; and the information required by this paragraph must be given notwithstanding that paragraph 21(3) of that Schedule (materiality) applies in relation to the accounts themselves.’

Disclosure requirements (FRS 102)

FRS 102, para 14.12 requires the following to be disclosed in the individual and group accounts:

- the accounting policy for investments in associates;
- the carrying amount of investments in associates; and
- the fair value of investments in associates accounted for using the equity method for which there are published price quotations.

Where the investor has received dividends or other distributions from the associate accounted for under the cost model, it must disclose the value of those dividends or distributions that have been recognised as income.

For equity accounted associates, disclose separately the investor’s share of the profit or loss of such associates and its share of any discontinued operations of such associates.

Where the fair value model has been used to measure investments in associates, disclose the information required by paragraphs 11.43 and 11.44 of FRS 102 (ie the basis for determining fair value, or if a reliable measure of fair value is no longer available for any financial instruments that would otherwise be required to be measured at fair value through profit or loss, disclose that fact).

In respect of the individual financial statements of an investor that is not a parent, disclose summarised financial information concerning investments in the associates, along with the effect of including those investments as if they had been accounted for using the equity method. Investing entities that are exempt from preparing consolidated financial statements, or which would be exempt if they had subsidiaries, are exempt from this disclosure requirement.