INVESTMENTS IN ASSOCIATES AND JOINT VENTURES IND AS 28

Chapter 2

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Objective

The objective of this Standard is to prescribe the accounting for investments in associates and application of the equity method when accounting for investments in associates and joint ventures.

Scope

This Standard shall be applied by all the entities who are investors having *joint control* or *significant influence* over an investee.

As per Section 129(3) of the Companies Act, 2013, "Where a company has one or more **subsidiaries**, it shall prepare a consolidated financial statements of the company". For this sub-section, the word "subsidiary" shall include ASSOCIATE COMPANY and JOINT VENTURE.

Hence, as per the Companies Act, 2013, every company **which has ONLY an associate company shall also** prepare consolidated financial statements and account for such investment in the associate **using Equity method** as described in this Standard. It means even though the entity does not have a subsidiary, it should still prepare CFS though the method of consolidation differs.

Concept capsule 1

A Ltd. is an associate to B Ltd. and it does not have any subsidiary. The accountant of B Ltd. is asking you whether B Ltd. should comply with Ind AS 28?

Suggested answer

Ind AS 28 is applicable to all the entities who are investors with joint control or significant influence over the investee and it is also as required by Section 129(3) of the Companies Act, 2013, "**where a *company has one or more subsidiaries, it shall prepare consolidated financial statements of the company". For this sub-section, the word "subsidiary" shall include ASSOCIATE COMPANY and JOINT VENTURE.***

In the given situation, B Ltd. is an investor with significant influence over A Ltd and hence, B Ltd needs to prepare consolidated financial statements. It means, the investment in associate should be measured using equity method in its consolidated financial statements. It should recognise the investment in accordance with Ind AS 27 in its separate financial statements.

Let us discuss about the meanings of important words used in this Standard.

Associate

It is an entity in which the investor has ***significant influence***.

What is significant influence?

It is the **power to participate** in the **financial and operating policy decisions** of the investee but **does not control or joint control of those policies.** Investor cannot take any decisions relating to financial or operating policies of the company but **they can take part in such decisions** of associate like being a member of the Board of the investee.

How does one entity get significant influence in another entity?

Significant influence may be gained by (1) share ownership; (2) statute; or (3) contractual arrangement.

Share ownership

Generally, it is **presumed** that investor has significant influence if it **holds 20% or more** of the voting power of the investee either directly or indirectly through subsidiaries and when such significant influence exists, the investee becomes an associate company to the investor and this standard is applicable. Even in the cases where the holding in the investee is 20% or more, if it can be **demonstrated that** the investor does not have significant influence over the investee, investor need NOT to comply with this Ind AS. Rather, it should comply with Ind AS 109 on "Financial instruments".

Conversely, if the investor holds *less than* 20% of the voting power, generally it is presumed that the investor does NOT have significant influence and does not need to comply with this Ind AS. ***BUT*** if the significant influence is **clearly demonstrated (though the holding is less than 20%)**, the investor should **follow equity method** to prepare consolidated FS as per this Ind AS.

A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

Concept capsule 2

What do you mean by **"Potential voting rights"?** Whether "Potential voting rights" are considered for establishing significant influence?

> ***Suggested answer***
>
> As per Ind AS 33 (Not defined by Ind AS 28) – these are the instruments or contracts **which may entitle** ordinary shares to its holders – E.g. convertible debentures, share warrants, options, etc. Refer Ind AS 33 for detailed discussion. Holders of such instruments are not equity shareholders as on the balance sheet date;
>
> These potential voting rights **should be considered ONLY when they are held, having economic substance and exercisable or convertible** by the investor as on the balance sheet date. By exercising these investor gets additional voting power and with which significant influence can be exercised.
>
> The entity should consider the facts and circumstances of each case, i.e. terms and conditions to exercise, etc and consider the financial ability to exercise or convert these potential rights. Only management intentions are not sufficient to determine.
>
> If potential voting rights are **NOT** currently exercisable or convertible – Do not consider the same to establish significant influence; i.e. if they cannot be exercised or converted on the balance sheet date but can be exercised at a future date or until the occurrence of a future event.

Shareholder's agreement

Shareholder's agreement normally contains clauses relating to the rights or power of minority shareholders i.e. to which extent the minority can participate in the financial or operating policies of the associate. This is an evidence of significant influence.

By statute

Government or Public Sector Units (PSU) can acquire some significant influence through a special statute over an entity operating in a regulated industry.

The following are the examples of having significant influence:

Representation on the board of directors or corresponding governing body of the investee; *(i.e. Investor appointed one or more directors of the associate)*

(a) Participation in policy making processes;
(b) Influencing by having material transactions with the associate;
(c) Having the power to change or interchange managerial personnel as per the agreement; or
(d) Providing *essential technical information* to the associate *(with this they have influence).*

The **loss of significant influence** can occur **with or without** a change in absolute or relative ownership levels. *For example*, when an associate becomes subject to the control of government, court, administrator or regulator. It could also occur as a result of a contractual arrangement.

> ***Concept capsule 3***
>
> Achyuta Ltd acquired 12% voting power in Govinda Ltd. Achyuta, being a single largest shareholder of Govinda, appoints the chairman and one other member of the BOD of Govinda Ltd (out of a total of 12 directors). These nominees of Achyuta Ltd are not directors of Achyuta Ltd. By virtue of its representation on the Board (through two nominees) of Govinda Ltd, Achyuta participates in the financial and operating policy decisions of the entity taken at the board meetings. Accountant of Achyuta confused whether to follow Ind AS 109 or Ind AS 28 in its consolidated financial statements?
>
> ***Suggested answer***
>
> As per Ind AS 28, associate is an entity in which the investor has significant influence and it can be gained through share ownership, statute or agreement. In general, it is presumed that the investor has significant influence if it holds 20% or more voting power either directly or indirectly.

Conversely, if investor holds less than 20% voting power and clearly demonstrate the significant influence, it becomes an associate.

In the given case, even though Achyuta holds only 12%, significant influence is clearly demonstrated by appointing a chairman, a BOD member and participating in financial and/or operating policies of the company. Considering this, Govinda Ltd is an associate to Achyuta and hence, Achyuta should comply with Ind AS 28 i.e. follow equity method of accounting for its investment in its preparation of consolidated financial statements.

Concept capsule 4

Holding (H Ltd) and Subsidiary (S Ltd) companies holds 15% & 6% respectively in A Ltd. Both i.e. Holding and subsidiary companies are preparing Consolidated financial statements (S Ltd. has two subsidiaries). Discuss accounting treatment in their CFS.

Suggested answer

As per Ind AS 28, an entity becomes an associate if the investor has 20% or more voting power in it either directly or indirectly unless otherwise proven to not be an associate.

In the given case, subsidiary company has only 6% voting power (less than 20%) hence A Ltd. is not an associate to it and it should account the investment as a financial asset as per Ind AS 109 in its consolidated financial statements.

In case of Holding company, it has total 21% voting power (directly 15% and indirectly 6% i.e. through subsidiaries), hence it should apply Ind AS 28 i.e. measure it's investment as per equity method of accounting in its CFS;

Concept capsule 5

Entity A owns 20% of the voting rights in entity B and is entitled to appoint one director to the board, which consists of five members. The remaining 80% of the voting rights are held by two entities, each of which is entitled to appoint two directors.

A quorum of four directors and a simple majority of those present are required to make decisions. The other shareholders frequently call board meetings at short notice and make decisions in the absence of entity A's representative. Entity A has requested financial information from entity B, but this information has not been provided. Entity A's representative has attended board meetings, but suggestions for items to be included on the agenda have been ignored and the other directors oppose any suggestions made by entity A. Is entity B an associate to entity A?

Suggested answer

As per Ind AS 28, generally it is presumed that investor has significant influence if it holds 20% or more of the voting power of the investee either directly or indirectly through subsidiaries and it is treated as an associate. If it is proved by **demonstrating** the investor does not have significant influence, investor need NOT to comply with this Ind AS and it should comply with Ind AS 109.

In the given case, despite the fact that the entity owns 20% of the voting rights and has representation on the board, the existence of other shareholders holding a significant proportion of the voting rights prevent the entity from exerting significant influence. Even though it appears that entity A should have the power to participate in the financial and operating policy decisions, the other shareholders **prevent** entity A's efforts and stop entity A from actually having any influence.

In this situation, entity B would **not be** an associate of entity A.

Concept capsule 6

Q Ltd manufactures shoes for a leading retailer P Ltd. P Ltd provides all designs for the shoes and participates in scheduling, timing and quantity of the production. The majority (i.e. 90%) of Q Ltd.'s sales are made to the retailer, P Ltd. P Ltd. has 10% shareholding in the Q Ltd. It acquired this interest many years ago at the start of their relationship. Does significant influence exist?

Suggested answer

As per Ind AS 28, if the investor holds less than 20% of the voting power, generally it is presumed that the investor does NOT have significant influence and does not need to comply with this Ind AS, BUT if it is clearly demonstrated otherwise, the investor has significant influence.

Q Ltd is highly dependent on the retailer for the continued existence of the business. Despite having only a 10% interest in Q Ltd, P Ltd has significant influence.

Concept capsule 7

Entity X and entity Y, operate in the same industry, but in different geographical regions. Entity X acquires a 10% shareholding in entity Y as a part of a strategic agreement. A new production process is key to serve a fundamental change in the strategic direction of entity Y. The terms of agreement provide for entity Y to start a new production process under the supervision of two managers from entity X. The managers seconded from entity X, one of whom is on entity X's board, will oversee the selection and recruitment of new staff, the purchase of new equipment, the training of the workforce and the negotiation of new purchase contracts for raw materials. The two managers will report directly to entity Y's board as well as to entity X's. Analyse.

Suggested answer

The secondment of the board member and a senior manager from entity X to entity Y gives entity X, a range of power over a new production process and may evidence that entity X has significant influence over entity Y. This assessment takes into the account what are the key financial and operating policies of entity Y and the influence this gives entity X over those policies.

Concept capsule 8

X Ltd owns 15% of the voting rights of Y Ltd., and the remainder are widely dispersed among the public.

X Ltd also is the only supplier of crucial raw materials to Y Ltd., further it provides certain expertise guidance regarding the maintenance of Y Ltd.'s factory.

Discuss the relationship between X Ltd. and Y Ltd.

Suggested answer

As per Ind AS 28, if the investor holds *less than* 20% of the voting power, generally it is presumed that the investor does NOT have significant influence and does not need to comply with this Ind AS, ***BUT*** if it is **clearly demonstrated otherwise**, there would be significant influence.

Y Ltd. is effectively functioning because of the participation of X Ltd. in the Y Ltd.'s factory despite having 15% interest in Y Ltd., X Ltd. has significant influence.

Concept capsule 9

Soul Ltd has 18% interest in God Ltd. Soul Ltd manufactures mobile telephone handsets using technology developed by God Ltd. God Ltd licenses the technology to Soul Ltd and updates the license agreement for new technology on a regular basis. The handsets are sold by Soul Ltd and represent substantially Soul Ltd's entire sale. Analyse.

> ***Suggested answer***
>
> As per Ind AS 28, if the investor holds less than 20% of the voting power, generally it is presumed that the investor does NOT have significant influence and does not need to comply with this Ind AS, BUT if it is clearly demonstrated otherwise, there would be significant influence.
>
> Soul Ltd is dependent on the technology that God Ltd supplies since a high proportion of Soul Ltd's sales are based on that technology. Therefore, Soul Ltd is likely to be an associate of God Ltd because of the provision of essential technical information.

Let us learn about "Joint venture" related words.

What is a Joint Venture?

Joint venture is a **joint arrangement** whereby **two or more parties** have a **joint control** over the joint arrangement i.e. parties have the right to net assets of the arrangement.

***Who are these parties to the joint arrangement? Does every party need to have control over the Joint venture*?**

There are two types of parties to the Joint venture based on the control. They are

1. **Venturer** who has joint control; and
2. Investor (does not have joint control but may have significant influence. *(below concept capsule helps you to understand better)*

What is a Joint Control?

Joint control is the contractually agreed sharing of control over an arrangement, which exists only when decisions about the **relevant activities require the UNANIMOUS CONSENT of the parties** sharing control**.**

Control is the **power to govern** the financial and operating policies of an arrangement so as to obtain benefits from it. Such contractual arrangement ensures that **NO** single venturer is in a position to unilaterally control the activity.

> ***Concept capsule 10***
>
> A Ltd, B Ltd & C Ltd. joined hands to do motor vehicle business by opening a new company X Ltd. As per their agreement, equal contributions and every important decision directly related to the objective of the business requires unanimous agreement of all the parties to the agreement. The accountant of A Ltd. argues whether the entity is an investor as it has above 20% stake or a venturer to the arrangement?
>
> ***Suggested answer***
>
> As per Ind AS 28 – Joint venture is a joint arrangement whereby two or more parties have a joint control over the joint arrangement i.e. parties have the right to net assets of the arrangement.
>
> The given situation has
>
> (a) Two or more parties are bound to the contractual agreement; and
>
> (b) The contractual agreement establishes the joint control among the parties. *(All relevant decisions require unanimous consent of parties).*
>
> Hence the business is a joint venture and the parties (A, B & C) are venturers and venturers should comply with Ind AS 28.
>
> It is **NOT** an Associate - An associate is an entity in which ***the investor has significant influence*** and which is *neither* a control *nor* a joint control. In the given situation every venturer has control over the governance of financial and operating policies of the business.
>
> But remember, we follow the **same equity method** under both the circumstances i.e. for accounting of investment in associate & joint venture;

Refer Ind AS110 for the meaning of "***Control";***

We mentioned the word "equity method" above. Let us learn equity method now.

Equity Method

Investor should **account for investment in associates and joint ventures by the application of Equity method** in its consolidated financial statements.

This method of accounting follows as below:

Step 1: **On the date of investment**

- Investment is initially **recorded at COST** (purchase consideration);
- We should measure whether there is goodwill/capital reserve in this investment; it should be computed as follows:

Calculation of goodwill/capital reserve

	₹
Purchase consideration i.e. cost of investment	XXX
Less: Proportionate value of entity's share of the **net FAIR value** of the investee's identifiable assets and liabilities on the date of acquisition of investment	XXX
Goodwill (positive)/capital reserve (negative)	**XXX**

- If it is goodwill, it should be part of carrying amount of investment. Remember, goodwill cannot be amortised – it will be tested for impairment as per Ind AS 36;
- Any excess of proportionate share of net identifiable assets over the cost of investment, should be **recognised directly in equity as capital reserve** added to the cost of investment and presented as capital reserve – *below concept capsules will help you to understand*;

Concept capsule 11

Rama Ltd purchased 30% stake in Raghava Ltd. on 1st April, 2018, for ₹34 lakh. Fair value of net assets of Raghava Ltd. on that date was ₹100 lakh. What would be the journal entry on 1st April, 2018 (i.e. date of acquisition) in consolidated financial statements? How would you record, if net assets fair value is ₹150?

Suggested answer

As per Ind AS 28, Rama Ltd holds 30% voting power which is more than 20%; hence it is presumed that it has significant influence. Hence it has to apply equity method for accounting investment in associate in its CFS.

As per the equity method, initially Investment should be **recorded at cost** and this should include goodwill/capital reserve identified.

Calculation of goodwill/capital reserve:

Particulars	**₹(in lakhs)**
Cost of investment	34
Less: Proportionate equity of associate on the date of acquisition	
(₹100 lakh × 30%)	30
Goodwill to be included in the carrying amount of investment	**4**

Amount of investment to be disclosed as on date of acquisition is ₹34 *(including goodwill of ₹4;*

Rama Ltd. records the following journal entry in CFS

Investment in associate (Raghava) …. Dr 34

To cash 34

(being investment in associate is initially recorded at cost and goodwill ₹ 4 of goodwill is identified)

If net assets fair value is ₹150

Calculation of goodwill/capital reserve:

Particulars	₹(in lakhs)
Cost of investment	34
Less: Proportionate equity of associate on the date of acquisition (₹150 lakh × 30%)	45
Capital reserve	**11**

Rama Ltd. records the following journal entry in CFS

Investment in associate (Raghava) …. Dr 45

To Cash 34

To Capital reserve 11

(being investment in associate is initially recorded at cost and capital reserve is recognised directly in equity)

Balance sheet date accounting (subsequent accounting)

A. The carrying amount of investment will be **increased or decreased** to recognise the **post-acquisition** change in investor's share in the ***net assets (equity)*** of the investee (Associate/Joint venture);

B. **Every change in equity of associate or joint venture after acquisition** should be reflected in the carrying amount of investment in the CFS of the investor, i.e. profits/losses earned and other comprehensive income (OCI).
   - The investor's share of the investee's profit or loss is recognised in the investor's profit or loss.
   - In the same way, the investor's share of those changes is recognised in the investor's other comprehensive income. As you know, changes in OCI arise from the revaluation of property, plant and equipment and from foreign exchange translation differences (FCTR), etc.

C. Distributions (dividend) **received** from the associate or joint venture should be **REDUCED from** the carrying amount of the investment;

Concept capsule 12 (Continuing with the previous concept capsule)

Rama Ltd purchased 30% stake in Raghava Ltd. on 1st April, 2018, for ₹34 lakh. Equity of Raghava Ltd. on that date was ₹100 lakh. Raghava Ltd. reported ₹50 lakh profit (before OCI) and Rs. 10 lakh OCI profit for the current year 2018-19. What would be the investment balance in consolidated financial statement of Rama Ltd. as on 31-03-2019? *(calendar year)*

Suggested answer

As per the above concept capsule, cost of investment is ₹ 34 lakh and that is the carrying amount and the goodwill is Rs. 4 lakh.

This carrying amount should be adjusted with the current year proportionate profit.

Particulars	₹
Net cost including goodwill/capital reserve as on DOA	34
Add: Share of post-acquisition period reserves (50 lakh × 30%)	15