MFRS Hot Topics

Additional investments in associates and joint ventures

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue provides guidance on the accounting of acquisition of additional investments in associates and joint ventures.

How should the purchase of an additional investment in an associate or joint venture be accounted for, if the investment continues to be an associate or joint venture?

Should any increase or decrease in the fair value of identifiable net assets relating to the previously held interest be recognised?

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General principles

An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition, any excess of the cost of the investment over the entity's share of the net fair value of the investee's identifiable assets and liabilities is included in the carrying amount of the investment (as notional goodwill). Any excess of the net fair values over cost is included as income in determining the entity's share of the investment's profit or loss for the period (MFRS 128.32). Subsequently, the investor's share of profit or loss is determined taking into account the acquisition-date fair values of the investee's assets and liabilities, for example by adjusting the depreciation or amortization amounts reported in the investee's own financial statements (MFRS 128.32). The investor must therefore determine the acquisition-date fair values of the investee's assets and liabilities in order to apply the equity method (ie perform a fair value exercise).

An additional investment in an associate or joint venture (that does not result in a change of status) is initially accounted for by adding the cost to the carrying amount of the investment. A new fair value exercise at the date of the subsequent investment is also required if its effect is material. This is in order to:

- determine whether the subsequent investment gives rise to an excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over cost. If so, that amount is recognised in profit or loss in the same way as any such excess on an initial investment in an associate or joint venture,

- recognise the appropriate share of profit or loss of the associate or joint venture subsequently. In our view this amount should be determined taking into account the fair values of the assets and liabilities at the date each tranche was acquired, and the related proportionate ownership interest acquired at each date (ie on a mixed measurement basis).

In certain circumstances, however, an entity may determine that a new fair value is not necessary because its effect on the subsequent equity accounting would be immaterial. For example, if the subsequent investment is made soon after the initial acquisition, the entity might conclude that it may rely on the initial or most recent fair value exercise. The entity must use judgement in making this determination.

This guidance applies only where the investment is an associate or joint venture both **before** and **after** the additional investment. In two other common situations:

Investment in an associate or joint venture becomes a subsidiary:	In this case, an entity follows the 'business combination achieved in stages' principles in MFRS 3.41 - 42
An existing investment becomes an associate or joint venture:	In this situation, the 'cost' of the associate or joint venture should include the cost of the additional interest and the carrying value of the existing investment. That carrying value of the existing investment will reflect its measurement basis, which will depend on its classification in accordance with MFRS 139. This will often be cost, since an investment in equity instruments that are not quoted in an active market and whose fair value cannot be reliably measured is required to be carried at cost (less any impairment losses) (MFRS 139.46(c)). Alternatively, the investment could be carried at fair value through profit or loss, or fair value through equity (for an available for sale investment). In the case of an available for sale investment, any gains or losses recognised in equity should **not be recycled** into profit or loss (ie they should remain in equity). Any previous impairment losses should not in our view be reversed.

Accounting of investment in associate or joint venture

MFRS 128 requires that an entity with joint control of, or significant influence over, an investee shall account for its investment in an associate or a joint venture using the equity method except in limited circumstances (MFRS 128.16-19). Under the equity method, "…on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition" (MFRS 128.10).

MFRS 128.32 requires that positive goodwill relating to an associate or a joint venture be included in its carrying value. Negative goodwill, referred to as an 'excess of the entity's share of the net fair value of the investee's identifiable assets, liabilities and contingent liabilities', is included as income. It is therefore necessary to determine the fair values of the identifiable assets etc. This exercise should be undertaken for each material separate investment.

An additional investment in an associate or joint venture and the subsequent share of the associate's profits or losses is determined taking into account the fair values of the assets and liabilities at the date each tranche was acquired (ie on a mixed measurement basis). MFRS 128.32 requires that "appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date." In the example below, the applicable adjustment in accordance with MFRS 128.32 would reflect the fair values at the date of acquisition of each 20% tranche.

In certain circumstances, an entity may determine that a new fair value exercise at the date the new tranche is acquired is not necessary due to materiality whereby it may conclude that it may rely on the initial or last fair value exercise. This may be the case when:

- the time lapsed between the initial investment and subsequent investment is not material,
- the amount of additional subsequent investment is not material,
- the nature of the associate's or joint venture's business is such that there is not likely to be a significant difference between book and fair value.

In these cases, although changes in the fair value of the investment in an associate or investment in a joint venture's identifiable net assets may have occurred during the period between the original and subsequent investment, these are reflected only to the extent of the application of equity accounting. At the time of the subsequent investment, there is no revaluation of the existing interest.

Example
Entity A acquires 20% of entity B for CU50 on 31 December 20X1 and this represents significant influence. At this date, the fair value of B's identifiable net assets is CU200. The cost therefore includes notional positive goodwill of CU10 (50 - (200 x 20%)).

During 20X2 to 20X4, entity B earns net profits of CU150, in accordance with IFRS.

On 31 December 20X4, entity A acquires a further 20% of entity B for CU100. At this date, the fair value of B's identifiable net assets is CU400. Additional notional positive goodwill of CU20 arises (100 - (400 x 20%)).

The accounting entries in entity A's consolidated financial statements are:

Initial recognition of 20% investment on 31.12.20X1	**Debit**	**Credit**
Cash		CU50
Investment in associate (including notional goodwill of CU10)	CU50	

Equity accounting 20X2 to 20X4	**Debit**	**Credit**
Income statement - share of profits of associate (CU150 x 20%)		CU30
Investment in associate	CU30	

Additional 20% investment on 31.12.20X4	**Debit**	**Credit**
Cash		CU100
Investment in associate (including notional goodwill of CU20)	CU100	

The 31 December 20X4 carrying value of the associate is CU180. This consists of the cost of the two investments of CU50 and CU100, along with the share of profits earned during the period of CU30. Although entity A owns 40% of entity B at 31 December 20X4, the carrying value will not equal 40% of B's net assets. The carrying value includes notional positive goodwill of CU30. In accordance with MFRS 128.32(a), this goodwill is not amortised. Further, the notional goodwill is not separately tested for impairment; the overall carrying value is tested for impairment, when necessary, in accordance with MFRS 128.42.

From 1 January 2015, entity A recognises its share of the associate's profit or loss based on a 40% ownership interest. In determining this amount, it should take into account the fair values of the associate's assets and liabilities at both acquisition dates (the 20% acquired on 31 December 20X1 and the additional 20% acquired on 31 December 20X4). For example, if the entity uses the associate's own IFRS financial statements as a starting point, it would:

- determine the gross (100%) adjustments required to depreciation and amortization charges to take account of differences between carrying amounts and fair value of depreciable assets at each date; and

- apply the relevant percentages (20% and 20%) to these gross adjustments to determine the net adjustment to the associate's reported results for equity accounting purposes.

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