



2

Accounting for Investments

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# 2

## LEARNING OUTCOMES

After studying this chapter students should be able to:

- ▶ explain the relationships between investors and investees;
- ▶ explain the different levels of investment and the conditions required for significant influence, control and joint control;
- ▶ explain the circumstances in which a subsidiary is excluded from consolidation;
- ▶ explain and apply the principles of recognition of goodwill based on the fair value of assets at the date of acquisition.

Achievement of the above learning outcomes will contribute to the overall learning aim of syllabus area A.

## 2.1 Introduction

This chapter introduces the appropriate accounting for investments in other entities. The extent of the investment will often determine the appropriate accounting treatment and this chapter examines the investments that will be accounted for as:

- Simple investments
- Investments in associates
- Investments in subsidiaries
- Investments in joint ventures

The focus is mainly on accounting for subsidiaries as the rules and requirements outlined will form the basis of the applications in Chapters 3 and 4.

The accounting for fair values in consolidation and the recognition of goodwill are also covered in this chapter.

## 2.2 Accounting for investments

Entities will often invest in the equity of other businesses. The extent of the equity shareholding will normally determine how the investment is accounted for. The accounting

treatment applied for investments is intended to reflect the importance of the investment in the financial statements of the investee and how the future performance and financial position might be affected by these investments. It follows then that the greater the level of investment the more detailed the financial information will be. A significant investment in another entity may require additional financial statements to be produced.

The accounting in the investees' *individual accounts* for all investments and for *simple investments* (commonly less than 20% of the total equity share capital of the entity invested in), will be determined by applying the recognition, measurement and disclosure requirements of the accounting standards that specifically deal with investments:

- IAS 32 Financial instruments: presentation
- IAS 39 Financial instruments: recognition and measurement
- IFRS 7 Financial instruments: disclosure

The provisions of these standards are dealt with in more detail in Chapter 11, however the basic impact on the financial statements will involve one entry in the statement of financial position (balance sheet) for *investments* and one entry in the income statement for *income* earned from these investments (dividend received).

## 2.3 Investment in associates

If an investor holds, directly or indirectly, 20% of the voting rights of an entity then it is normally considered an associated entity and is accounted for in accordance with IAS 28 *Investments in Associates*. IAS 28 states that there is a presumption that the investor has significant influence over the entity, unless it can be clearly demonstrated that this is not the case.

The key concept in the definition is 'significant influence'. IAS 28 explains that significant influence is the power to participate in the financial and operating policy decisions of the entity but is not control over those policies. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

- representation on the board of directors
- participation in policy-making processes
- material transactions between the investor and the entity
- interchange of managerial personnel
- provision of essential technical information.

The impact of this level of investment on the investing entity is likely to be greater than that of a simple investment. There is greater exposure to the results of the associate and a decline in its value will have a greater negative impact on the statement of financial position of the investing entity. The information provided therefore is a step further than that provided for simple investments.

The investment in the associate is equity accounted (covered in depth in Chapter 5) and the investment shown in the statement of financial position will include the investing entity's share of the gains of the associate from the date the investment was made. The investing entity will show the share of realised and recognised gains it is entitled to by virtue of this investment rather than just the dividend received.

## 2.4 Investment in subsidiaries

It is often the case that businesses conduct part of their operations by making investments in other business entities. For example, a business that aims to expand its market share could opt to purchase one or more of its competitors, rather than taking the slower route of building market share by gradual organic growth. Another example is where a business purchases an investment in one or more of its suppliers of key goods and services in order to integrate and secure its supply chain.

In order to fulfil the needs of investors and other users, additional information is likely to be required, and therefore the IASB has in issue several accounting standards setting out the principles and practices that must be followed where an investment comprises a significant proportion of the total equity of the investee entity.

### 2.4.1 The principle of control

This chapter will start to examine the accounting required under IFRS for investments in subsidiaries. The accounting standard that sets out the requirements for recognition of an entity as a subsidiary is IAS 27 *Consolidated and Separate Financial Statements*. This standard was revised in January 2008, but its basic principles have been part of IFRS for many years.

First, some relevant definitions taken from the standard:



A *parent* is an entity that has one or more subsidiaries.

A *subsidiary* is an entity, including an unincorporated entity such as a partnership, which is controlled by another entity (known as the parent).

The key concept in determining whether or not an investment constitutes a subsidiary is that of *control*.



*Control* is the power to govern the financial and operating policies of an entity so as to obtain benefit from its activities.

There is a presumption that control exists where the investor entity owns over half of the voting power of the other entity. If an investor entity, ABC, owns 55% of the voting share capital of entity DEF, in the absence of any special circumstances, ABC is presumed to be in control of DEF. The maximum investment that could be held by another investor is 45%, and so ABC will always have the capacity to win a vote over the other investor(s). The nature of the relationship between ABC and DEF is that of parent and subsidiary.

In most cases, control can be easily determined by looking at the percentage ownership of the ordinary share capital in the investee entity. Provided ownership is greater than 50% a parent/subsidiary relationship can be assumed. However, there are exceptions. A parent/subsidiary relationship can exist even where the parent owns less than 50% of the voting

power of the subsidiary since the key to the relationship is control. IAS 27 supplies the following instances:

When there is:

- (a) power over more than half of the voting rights by virtue of an agreement with other investors;
- (b) power to govern the financial and operating policies of the entity under a statute or agreement;
- (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- (d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

The reason for describing the nature of control in such detail in IAS 27 is that entities have sometimes created ownership structures designed to evade the requirements for accounting for subsidiaries.



In the Financial Management examination, questions may be set that test understanding of the principle of control, and it is possible that you will be required to explain these conditions in a written question.

## 2.4.2 The requirement to prepare consolidated financial statements

Where a parent/subsidiary relationship exists, IAS 27 requires that the parent should prepare consolidated financial statements. It is important to realise from the outset that this is an additional set of financial statements. The parent and subsidiary continue to prepare their own financial statements. Therefore in a group comprising one parent and one subsidiary, a total of three sets of financial statements are required. Where a group comprises, say, the parent and four subsidiaries, a total of six sets of financial statements are required: one for the parent, one for each of the four subsidiaries and one set of consolidated financial statements.

## 2.4.3 Exclusion from preparing consolidated accounts

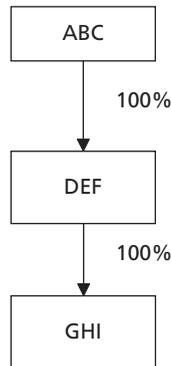
A full set of financial statements in addition to those already prepared is, of course, quite an onerous requirement. IAS 27 includes some exemptions, as follows:

A parent need not present consolidated financial statements if and only if:

- (a) the parent is itself a wholly owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
- (b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

- (c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market;
- (d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRS.

These provisions have been spelt out in some detail so as to minimise the risk of entities evading the accounting requirements. It will be apparent, though, that quite a lot of groups are not, in fact, required to prepare consolidated financial statements. This is particularly relevant where there are 'vertical' group structures, such as the one illustrated below:



There are two groups within this structure:

the DEF group, where DEF owns 100% of its subsidiary, GHI.

the ABC group, where ABC owns 100% of its subsidiary DEF.

The IAS 27 exemption means that only one set of consolidated financial statements has to be prepared: for the ABC group. DEF is exempted from the requirement. If only 55% of the voting capital of DEF was owned by ABC, and non-controlling interests held the remaining 45%, DEF can still be exempted from the requirement to prepare consolidated financial statements provided that the non-controlling interests do not object.

The only other exemption from the requirement to consolidate is in respect of an investment in subsidiary that has been acquired exclusively with the intention of reselling it. The provisions of **IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*** apply: the sale must be highly probable, i.e. there must be a plan to sell the asset and the asset must be actively marketed. The sale should be expected to qualify for recognition as a completed sale within one year of its classification as held for sale. It is not therefore possible for a parent's management to decide not to consolidate a subsidiary that has previously been consolidated on the grounds that they intend to sell it at some point in the future. It is obviously important to prevent this approach so that unscrupulous managers do not remove loss-making subsidiaries from the consolidation process.

#### 2.4.4 Goodwill

When a controlling investment is made the parent is investing in the net assets of the subsidiary. The value of the assets presented on the statement of financial position is unlikely to be what is paid by the investing entity.

Usually, the owners of a profitable business will expect to receive more in exchange for the investment than its net asset value. This additional amount arises for various reasons. It

is quite likely that the assets recognised in the statement of financial position do not represent all the assets of the firm but intangibles such as good reputation and customer loyalty may be worth something to the purchaser. The difference between the cost of investment and the fair value of the net assets acquired is known as **goodwill on acquisition**, and the accounting standard IFRS 3 *Business Combinations* requires its recognition in consolidated financial statements.

### 2.4.5 IFRS 3 Business combinations

IFRS 3 was originally issued in March 2004 replacing an earlier standard. However, it was just the first stage in a longer term IASB project on accounting for business combinations. The next stage culminated in the issue, in January 2008, of the revised version of IFRS 3.

IFRS 3 requires that entities should account for business combinations by applying the **acquisition method of accounting**. This involves recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree entity (the recognition and measurement of non-controlling interests will be explained in Chapter 3). Measurement should be at fair value on the date of acquisition. Where 100% of the equity of a subsidiary is acquired, goodwill on acquisition is calculated as follows:

Goodwill on acquisition is the aggregate of:

Consideration, measured at fair value

LESS

Net assets acquired (the fair value of identifiable assets acquired less liabilities assumed)

This measures goodwill on acquisition which is recognised in the consolidated financial statement of position within non-current assets. Goodwill on acquisition is an asset of the group (not of the individual entities within the group) and is subject to impairment reviews to ensure its value is not overstated. The goodwill arises at the date of acquisition and will not change unless impairment is identified, whereby it will be held net of impairment losses (which should be recognised in accordance with IAS 36 *Impairment of Assets*).

Practical application of recognising and measuring goodwill will be covered in the remaining chapters for Syllabus section A.

### 2.4.6 Fair values in acquisition accounting

IFRS 3 requires that whenever a group entity is consolidated for the first time the purchase consideration and the group share of the net assets of the acquired entity are measured at fair values. The difference between these two figures is goodwill. The purpose of a fair-value exercise is to apportion the consideration given by the parent to purchase the shares in the newly acquired entity to the net assets of the newly acquired entity for consolidation purposes. Any difference between the fair value of the consideration given and the fair values of the net assets acquired is goodwill on acquisition.

As far as the net assets of the acquired entity are concerned, the amounts that are initially consolidated should normally be restricted to net assets of the acquired entity that existed at the date of the acquisition. They should be recognised separately as at the date of acquisition if they satisfy IFRS 3's criteria for recognition:

- In the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably.

- In the case of a liability other than a contingent liability, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and its fair value can be measured reliably.
- It is an intangible asset that meets the IAS 38 *Intangible Assets* definition.
- In the case of a contingent liability, its fair value can be measured reliably.

### General principles

Fair value is defined in IFRS 3 as:



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

As a general rule, fair value is market value. More detail regarding the fair valuation of specific assets and liabilities is given below.

The cost of a business combination should represent the fair values of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree.

### Fair value of consideration

Fair value must be measured at the date of the exchange. In cases where the acquisition is for the asset of cash, measurement of fair value is straightforward. However, in some cases the consideration offered will comprise equity shares, wholly or in part. Where this is the case, the shares must be valued at fair value. The published price at the date of exchange is the best evidence of fair value where the equity instruments are listed on a stock exchange. The only exception to this is if, for some reason, the market value of the relevant instrument at the date of acquisition is unusually high or low (e.g. if world events have resulted in a temporary significant downturn in market values of securities). In such circumstances it would be necessary to consider the market value of the instrument around the date of acquisition to arrive at a representative and realistic figure for fair value.

A special case involves contingent consideration:

Entity A might pay \$8 million to acquire the shares of entity B, but the contract may be subject to a clause relating to contingent consideration which stipulates that if certain criteria are met in the first year of ownership (relating perhaps to profitability), a further \$1 million will be payable to the former shareholders of B. Where an element of the consideration is contingent on future events, that element should be included in the overall cost of the acquisition if the adjustment is probable and can be measured reliably. Occasionally the terms of the agreement may be such that it is impossible to say whether, and if so how much, additional consideration will be paid, and in such circumstances, the group accounts may have to simply disclose the matter, rather than by making provision. The fair value of the contingent consideration should be based on the present value of future consideration payable.

Any costs incurred in the business combination (legal fees, etc.) will be written off as expenses in the period.

Costs of issuing financial instruments in connection with the acquisition should *not* be included as part of the fair value of consideration. Instead, they are included as part of the initial measurement of the financial instrument, in accordance with IAS 39 (see Chapter 11).

### Property, plant and equipment

Fair value should be based on depreciated market value unless (in the case of plant and equipment) there is no evidence of market value because of the specialised nature of the plant and equipment or because it is rarely traded, except as part of a continuing business. In such cases fair value should be based on depreciated replacement cost.

### Inventories

Where inventories are replaced by purchases in a ready market, the fair value = market value. However, where, as in the case of manufactured inventories, there is no ready market fair value is the current cost to the acquiring entity of obtaining the same inventories. If no current cost figure is readily available (as may well be the case) it can be approximated by taking inventories at sales values less:

- costs to complete (for work-in-progress inventories)
- incidental costs of disposal
- a realistic allowance for profit.

### Listed investments

In most cases, the price quoted at the date of exchange will represent fair value.

### Intangible assets

The acquirer should recognise an intangible asset of the acquiree at the date of acquisition provided that it meets the definition of an intangible asset provided by IAS 38 *Intangible Assets*, and that it can be measured reliably. Intangible assets must be separable (i.e. must be capable of being separated and divided from the entity and of being sold) or they must arise from contractual or legal rights.

### Monetary assets and liabilities

The fair value should be based on the amounts due to be received or paid. For many monetary assets and liabilities, the fair value will be the amount at which they are stated in the subsidiary undertaking's statement of financial position at the date of exchange. However, the fair value of some long-term monetary items may be materially different from book value, for example, where an acquired entity is carrying material amounts of long-term borrowings at fixed rates that are not representative of current interest rates. Where fair value is materially different from book values, fair value should be used. It may be necessary, in respect of unlisted financial instruments, to estimate fair value by discounting to present value amounts expected to be received or paid.

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#### Example 2.A

A newly acquired subsidiary has in issue \$10 million 5% loan stock that is redeemable at par in 5 years' time. Current market interest rates are 8%. The relevant cash flows are \$500,000 per year for 5 years in respect of interest and then a repayment of \$10 million in 5 years' time. In order to approximate the fair value of the instrument these cash flows are discounted at 8%, as follows:

An annuity of \$500,000 for 5 years:  
 $3.993 \times 500,000 = \$1,996,500$   
 Plus a payment of \$10m in 5 years' time:  
 $0.681 \times \$10\text{m} = \$6,810,000$   
 Total fair value = \$8,806,500.

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### Provisions for restructuring

Only the identifiable assets, liabilities and contingent liabilities of the acquiree that exist at the year end date can be recognised separately by the acquirer as part of allocating the cost of the combination. IFRS 3 states that: ‘future losses or other costs expected to be incurred as a result of a combination are not liabilities incurred or assumed by the acquirer in exchange for control of the acquiree, and are not, therefore, included as part of the cost of the combination’.

### Contingent liabilities

Contingent liabilities, in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, are not recognised in financial statements. However, by contrast, IFRS 3 requires that the contingent liabilities of an acquiree are recognised at fair value at the date of acquisition provided that their fair value can be measured reliably. Therefore, when calculating goodwill on acquisition, it is important to remember to include all measurable contingent liabilities. Note that contingent assets are not recognised by the acquiring entity.

## 2.5 Investment in joint ventures

Where an entity enters into an arrangement whereby control over an economic activity is shared between it and other parties, a joint venture arrangement exists. A joint venture can take a number of forms (will be covered in depth in Chapter 5), however one of those is where a new entity is formed and since that entity is under joint control it will be consolidated.

Again the method of accounting reflects the level of the investment made – it is greater than significant influence (associate) but not as much as full control (subsidiary). The joint venture will be consolidated but not using the full consolidation method. Instead IAS 31 *Interests in Joint Ventures* requires that joint ventures be proportionally consolidated. This will involve only aggregating the parent’s share of the JV’s assets, liabilities, revenues and expenses.

The practical application of proportionate consolidation will be covered in depth in Chapter 5.

## 2.6 Summary

This chapter has reviewed the accounting for investments and looked at how the different levels of investment warrant different accounting treatment. The introduction to accounting for subsidiaries included a review of the principles of control, how to determine fair values of assets and liabilities acquired and how to recognise goodwill on acquisition. The requirements that have to be met to be excluded from preparing consolidated financial statements were also covered.

This chapter covered some key principles in the consolidation process and you may find that you refer back to it as you progress through Chapters 3 to 9.

# Revision Questions

# 2

The questions below are intended to be tests of understanding. They are not of exam standard as this area is likely to be tested within a question that also covers other technical areas.

## Question 1

Where the purchase price of an acquisition is less than the aggregate fair value of the net assets acquired, which ONE of the following accounting treatments of the difference is required by IFRS 3 *Business Combinations*?

- (A) Deduction from goodwill in the consolidated statement of financial position?
- (B) Immediate recognition as a gain in the statement of changes in equity?
- (C) Recognition in the statement of comprehensive income over its useful life?
- (D) Immediate recognition as a gain in profit or loss.

## Question 2

PQR holds several investments in subsidiaries. In December 20X5 it acquired 100T of the ordinary share capital of STU. PQR intends to exclude STU from consolidation in its group financial statements for the year ended 28 February 20X6, on the grounds that it does not intend to retain the investment in the longer term.

Explain, with reference to the relevant International Financial Reporting Standard, the conditions relating to exclusion of this type of investment from consolidation.

## Question 3

On 30 September 20X5 GHI purchased 80% of the ordinary share capital of JKL for \$1.45 million. The book value of JKL's net assets at the date of acquisition was \$1.35 million. A valuation exercise showed that the fair value of JKL's property, plant and equipment at that date was \$100,000 greater than book value, and JKL immediately incorporated this revaluation into its own books. JKL's financial statements at 30 September 20X5 contained notes referring to a contingent liability (with a fair value of \$200,000).

GHI acquired JKL with the intention of restructuring the latter's production facilities. The restructuring plan, including a detailed estimate of costs, was well advanced at 30 September 20X5. The estimated costs totalled \$115,000.

Calculate goodwill on acquisition, and identify any of the above items that should be excluded from the calculation in accordance with IFRS 3 *Business Combinations*.

## Question 4

AB purchase 100% of the equity share capital of CD and at the date of acquisition the net assets of CD were reviewed and the following is discovered:

- The intangible non-current assets of CD at the acquisition date, consist of the estimated value of a brand that is associated with the entity. This estimate has been made by the directors and no reliable external estimate of the market value of the brand is available.
- Relevant details of tangible non-current assets of CD are:

<i>Description</i>	<i>SOFP carrying value</i> \$'000	<i>Market value</i> \$'000	<i>Depreciated replacement cost</i> \$'000	<i>Recoverable amount</i> \$'000
Property	10,000	12,000	Not given	13,500
Plant	10,000	Not given	11,000	14,000

- Inventories of CD comprise:
  - Obsolete inventory (year end value: \$500,000). This inventory has a net realisable value of \$300,000.
  - The balance of inventory (statement of financial position value: \$3,500,000). This inventory has a net realisable value of \$4,200,000. A reasonable profit allowance for the sale of the inventory would be \$400,000.
- The provision of \$1 million in the statement of financial position of CD is against the reorganisation costs expected to be incurred in integrating the entity into the Sea group. These costs would not be necessary if CD were to remain outside the group. Although the plan was agreed by the board of directors before the acquisition date, it was not made known to those affected by the plan until after that date.

Discuss how the above will affect the fair value of the identifiable net assets in calculating goodwill.

## Question 5

On 31 July 20X7, AGR acquired 80% of the ordinary share capital of its subsidiary BLK. The book value of BLK's net assets at the date of acquisition was \$1,300,000. This value included \$300,000 in respect of certain specialised items of plant, which were bought on 31 July 20X4. The plant is being depreciated on a straight line basis over 6 years with an assumption of nil residual value. No estimate of market value at the date of acquisition is available, but it would cost \$700,000 to replace the plant at current prices.

Since 20X5, BLK has been developing a specialised industrial process. Following registration of the patent and some coverage in the trade press, BLK received an offer for the patent of \$150,000 in April 20X7. The offer was rejected. BLK does not recognise the patent as an asset. AGR's directors think it probable that other processes developed by BLK have a market value, and they have made a broad estimate of \$75,000 to cover such items which have not been capitalised by BLK.

Shortly before the acquisition of BLK took place, its directors had started a programme to rationalise production. The estimate cost of the programme was \$250,000, but no provision for it was recognised in the entity's financial statements at 31 July 20X7. The programme has continued and is now (November 20X7) substantially complete.

Calculate the fair value of BLK's net assets that would be included in the consolidated statement of financial position of AGR at 31 July 20X7, assuming that there are no relevant issues other than those given above. If appropriate, explain your reasons for excluding any of the possible adjustments to fair value.

# Solutions to Revision Questions

# 2

## ✓ Solution 1

The correct answer is (D).

## ✓ Solution 2

According to IFRS 5 *Non-Current Assets held for Sale and Discontinued Operations*, a subsidiary that has been acquired and is held exclusively with a view to its subsequent disposal, does not require consolidation. However, the investment can be regarded as 'held for sale' only if its disposal is intended to take place within 12 months of the date of statement of financial position. In the case of PQR's investment in STU, the disposal would have to take place before 28 February 20X7.

## ✓ Solution 3

Goodwill on acquisition

	\$	\$
Investment in JKL Acquired:		1,450,000
Net assets at book value	1,350,000	
Revaluation	100,000	
Contingent liability	<u>(200,000)</u>	
	1,250,000	
80% of fair value of net assets		<u>1,000,000</u>
Goodwill on acquisition		<u>450,000</u>

According to IFRS 3, restructuring provisions can be taken into account only if the acquiree has an existing liability for restructuring recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This condition is not met in this case.

## ✓ Solution 4

1. No value should be attached to the intangible asset when determining fair value of net assets acquired since there is no reliable market value.
2. The fair value of the property should be based on the market value of \$12,000,000.

3. The obsolete inventories should be included at the NRV of \$300,000. The remaining inventories are carried at \$3,500,000, however the fair value can be taken as the sales value less realistic allowance for profit. The fair value of these inventories is therefore \$3,800,000.
4. No amount should be included for the provision. Although the plan is approved it has not been communicated to those that will be affected (e.g. employees, customers, suppliers, etc.) and so as per IAS 37 no constructive obligation exists. IFRS 3 only allows provisions where there is a constructive obligation.



### Solution 5

	\$'000
Book value before adjustment	1,300
Fair value adjustment for PPE: replacement cost of \$700,000 less 3/6 years depreciation = \$350,000	
Uplift in value: \$350,000 – 300,000	50
Recognition of intangible asset	150
Provision for rationalisation programme	<u>(250)</u>
Fair value at 31 July 20X7	<u>1,250</u>

The director's valuation of \$75,000 in respect of other patents has been excluded from the fair value calculation because (i) there appears to be insufficient evidence that the intangibles are separable; and (ii) the broad general estimate probably does not meet the requirement that such assets should be measured reliably.