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Article

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Abstract

This article focuses on the main items regarding the identification of associated enterprises and joint ventures, and make useful guidelines related to the equity method, with reference to international standards. Also, it presents the perspectives on evaluation and the implications its practical approach of investments in associates and joint venture. The results show that this approach of the issue mentioned is very useful for correct understanding and practice by potential investors.

Key words

Equity method, IAS 28, financial statements, investments

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1. Introduction and literature review

IAS 28 - Investments in associates and joint ventures attracted the attention of both theoreticians and that of the practitioners. An associate is an entity over which the investor has significant influence (Soonawalla, 2006). At the same time, significant influence is the ability to participate in decisions making regarding financial and operating policies of the investee entity without exercising control or joint control over those policies (Mantecon *et al*., 2012).

An important statement of O'Hanlon and Taylor (2007) is that the joint control represents sharing of control over an undertaking, agreed upon in a contract, which exists only when decisions about the relevant activities require the unanimous consent of the parties with joint control.

By extension, So *et al*. (2018) reiterates the idea that the financial statements of the investor and the investee entity (associate or joint venture) may have different closing dates, but the difference cannot be more than three months. Where there are differences when adjustments shall be made to take into account the effects of significant transactions or events occurring between the date of the financial statements of the investee entity and the investor.

2. The evaluation and presentation the investments in associates and joint ventures

IAS 28 defines joint control as sharing of control over an undertaking, agreed upon in a contract, which exists only when decisions about the relevant activities require the unanimous consent of the parties with joint control. As well, the equity method is a method of accounting whereby the investment is initially recognized at cost and subsequently adjusted according to post-aquisitional changes of investor's share of net assets of the investee. The profit or loss of the investor includes its share of the profit or loss of the investee, and other comprehensive income of the investor includes its share of other comprehensive income of the investee entity.

On the other hand, IAS 28, requires the investor will recognize investments in associates or joint ventures:

a) *the individual financial statements* either: (i) at cost; or (ii) at fair value through profit or loss under IFRS 9

b) *the consolidated financial statements* - IAS 28 - by applying the equity method.

If the investor *does not prepare consolidated financial statements*, Due to the fact that it has no branches but has financial investments in associates or joint ventures when they are presented in the investor's financial statements at cost or be at fair value under IFRS 9.

However, IAS 28 provides the following exemptions from the application of the equity method:

1. if the investment is classified as "held for sale" in accordance with IFRS 5, in this case it is accounted for in accordance with IFRS 5. (IAS 28.15)

2. an entity is required to apply the equity method for its investment in an associate or a joint venture if the entity is a main company that is waived the consolidated financial statements by derogation from the scope of the IFRS 10 or if all the conditions below:

a) entity is a wholly owned subsidiary or is a partially-owned subsidiary of another entity and its other owners, including those who otherwise have no right to vote, have been informed and did not object to that entity does not apply method equity;

b) debt instruments or equity of the entity are not traded in a public market (a domestic or foreign stock exchange or an unregulated market (OTC), including local and regional markets);

c) entity did not file, nor is about to submit their financial statements in a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market;

d) parent intermediate or ultimate parent entity produces financial statements available for public use that comply with IFRS, the subsidiaries are consolidated or measured at fair value through profit or loss in accordance with IFRS 10. (IAS 28.17)

If an investor has significant influence over an entity when it is an associate. IAS 28 states that when an entity (investor) holds:

1. 20% or more of the voting rights of an investee entity, it normally requires that the investor has significant influence

2. less than 20% of the voting rights of an investee entity is assumed, usually it does not exercise significant influence (IAS 28.5).

The investor may hold its interest directly or indirectly through its subsidiaries. However, there may be situations where the investor does not have significant influence even if it has 20% or more of the voting rights of an investee entity. Moreover, there may be situations where the investor owns 20% or less of the voting rights of an investee entity but exerts significant influence. (IAS 28.5)

The following situations are presented in standard as evidence of significant influence:

1. representation on the board of directors or equivalent governing body of the investee entity;
2. participation in policy-making, including participation in decisions about dividends or other distributions;
3. material transactions between the entity and the entity in which it has invested;
4. interchange of managerial personnel; or
5. provision of essential technical information.(IAS 28.6)

If an entity is owned by several investors and one of them has a substantial or majority, this does not necessarily preclude another investment/other investors to exercise a significant influence over the prisoners. (IAS 28.5)

In examining whether significant influence does exist or not, it will be taken into account the existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities. Potential voting rights that are *currently exercisable* or convertible must be taken into account because an entity may own warrants on shares, options to purchase equities, debt or equity securities that are convertible into ordinary shares or other financial instruments - if exercised or converted - and that can lead:

a) either providing entity that holds more voting rights;

b) or reduce the voting rights of another party's financial and operating policies of another entity (i.e. potential voting rights).

It is considered that potential voting rights *are not currently exercisable or convertible* if they cannot be exercised or converted *until a future date* or *until the occurrence of a future event*. (IAS 28.7) If the investor loses the power to participate in decisions making regarding financial and operating policies of the investee entity, then we can say that it has lost significant influence. ([IAS 28.9)

A joint venture *type of shared commitment* where the parties have joint control of the undertaking, and they have *rights to the net assets of the undertaking*. The respective parts of the call partner in a joint venture. There may be joint commitments which the parties have rights to the assets and obligations for liabilities related to commitment. This type of commitment is called joint venture operation and not covered by this material, nor applies the equity method.

3. Results and discussions

IAS 28 allows *election* fair value through profit and loss sharing application of the equity method when:

a) an investment in an associate or a joint venture is owned directly or indirectly through an entity that is an organization with venture capital mutual fund, an investment fund and similar entities, including funds insurance investment component.

b) an entity holds an investment in an associate and part of it is held indirectly through an organization with venture capital mutual fund, an investment fund and similar entities, including funds linked insurance investment. Part of it is measured at fair value through profit or loss regardless of whether the organization of venture capital mutual fund, the investment fund and similar bodies, including funds linked insurance investment exert a significant influence on that part of the investment. Accordingly entity applies the equity method for any remaining part of its investment in an associate that is not owned by a venture capital organization or a mutual fund, an investment fund and similar entities, including funds linked insurance investment. (IAS 28.19)

IAS 28 also requires *interruption* using the equity method from the date when its investment ceases to be an associate or a joint venture as follows:

1. If the investment becomes a subsidiary, the entity shall account for its investment in accordance with IFRS 3 Business Combinations and IFRS 10.

2. If the interest retained in the former associate or joint venture is a financial asset, the entity shall assess the fair value of retained interests. The fair value of retained interest must be regarded as its fair value on initial recognition as a financial asset in accordance with IFRS 9. The entity shall recognize in profit or loss any difference between:

2.1 *fair value* - any retained interest and any proceeds from disposing of part of its interest in the associate or joint venture; and

2.2 *book value* - on interruption of the investment using the equity method.

3. When an entity discontinues using the equity method, the entity shall account for all amounts previously recognized in other comprehensive income in relation to that investment on the same basis envisaged when the entity investee would be directly disposed assets or liabilities related.

Concerning transactions between the investor and the investee will take into account the following aspects (IAS 28.28, 29.31, 35, 38, 39):

- gains and losses arising from transactions "downstream" and "upstream" involving assets that is not an undertaking as defined in IFRS 3, between the investor (including its consolidated subsidiaries) and the entity of the investee (associate or joint ventures) are recognized in the investor's financial statements only to the extent of other unrelated investors in the entity concerned;
- when transactions "downstream"/"upstream recognize:

a) *full loss* in the case of "downstream";

b) *share* the loss transactions "upstream"

- gains or losses from a transaction "downstream" involving assets representing an enterprise as defined in IFRS 3, between an entity (including its consolidated subsidiaries) and the entity associated or association ventures are recognized in full in cases financial investor.

Regarding the accounting policies IAS 28 requires the entity's financial statements shall be prepared using uniform accounting policies for transactions and similar events occurring in similar circumstances and consequently the cumulative effects of changes in accounting policies - made to unify the policies of the entity that invested by the investor - must be reflected in the financial statements of the investor.

Whether the entity investee has outstanding cumulative preference shares that are held by parties other than the investor (which in this case is not an investment entity) and classified as equity, the entity computes its share of profits or losses after the adjustment to take into account the dividends on such shares, whether or not dividends have been declared.

4. Conclusions

The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture established by using the equity method, and any long-term interests that, in fact, part of entity's net investment in the associate or joint venture. For example, an item for which settlement is neither planned nor likely in the foreseeable future is, in fact, an extension of the entity's investment in associate or joint venture. Such items may include preference shares and long-term receivables or loans but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans. Losses recognized under the equity method in excess investment in ordinary shares are attributed entity other components of the entity's interest in an associate or a joint venture in the reverse order of their seniority (i.e. priority in liquidation) trade payables or any long-term receivables for which adequate collateral exists, such as secured loans. Losses recognized under the equity method in excess investment in ordinary shares are attributed entity other components of the entity's interest in an associate or a joint venture in the reverse order of their seniority (i.e. priority in liquidation) trade payables or any long-term receivables for which adequate collateral exists, such as secured loans. Losses recognized under the equity method in excess investment in ordinary shares are attributed entity other components of the entity's interest in an associate or a joint venture in the reverse order of their seniority (i.e. priority in liquidation).

In conclusion, after holding entity is reduced to zero, additional losses are accounted for and a liability is recognized only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. If the associate or joint venture subsequently reports profits, the entity resumes recognizing its share of those profits only after its share of the profits equals the share of losses not recognized.

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