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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

CL-25-1 | Corporate Financial Reporting

Corporate Level (2025 – Curriculum)

- Consolidated Financial Statements – Part 4

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ASSOCIATES (LKAS 28)

LKAS 28 Investments in Associates and Joint Ventures deals with identifying and accounting for an associate. The **principles of equity accounting** are applied in accounting for associates in the financial statements.

Definitions

Associate	An associate is an entity, over which the investor has significant influence
Significant influence	The **power to participate** in the financial and operating policy decisions of the investee but is not control or joint control of those policies.
Equity accounting	Equity accounting is a method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of the net assets of the associate.

SIGNIFICANT INFLUENCE

As per LKAS 28, Significant influence is the **power to participate** in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

Significant influence can be determined by the holding of voting rights (usually attached to shares) in the entity. LKAS 28 states that if an **investor holds 20% or more (usually 20% to 50%)** of the voting power, directly or indirectly, of the investee, it can be presumed that the investor has significant influence over the investee, unless it can be clearly shown that this is not the case.

Therefore, Significant Influence can be presumed not to exist if the investor holds less than 20% of the voting power of the investee.

The existence of significant influence is evidenced in one or more of the following ways.

1) Representation on the board of directors (or equivalent governing body) of the investee
2) participation in policy-making processes, including participation in decisions about dividends or other distributions
3) Material transactions between investor and investee
4) Interchange of management personnel
5) Provision of essential technical information

Investments in associates in the separate financial statements of the investor

An investment in an associate is accounted for in the separate financial statements of the investor either:

(a) At cost, or
(b) Using the equity method (LKAS 28), or
(c) In accordance with SLFRS 9 (at fair value)

This treatment applies whether or not consolidated financial statements are prepared.

EQUITY METHOD OF ACCOUNTING

LKAS 28 requires that all investments in associates are accounted for **in the consolidated financial statements** using the equity method unless an exemption applies.

LKAS 27 permits use of the equity method when accounting for investments in subsidiaries, joint ventures and associates in an investor's **separate financial statements**.

Principles of equity accounting when preparing consolidated financial statements

Consolidated Statement of Financial Position	• A single figure for investment in associates is shown. • At the time of the acquisition (Initial Measurement), this is stated at cost. • This is subsequently increased or decreased by the group's share of post-acquisition reserves of the associate.
Consolidated Statement of Profit or Loss and Other Comprehensive Income	• The group share of the profit or loss of the associate is recognized together with group share of the associate's other comprehensive income earned during the post-acquisition period.

Exemption from application of equity method

- LKAS 28 states that if an investment in an associate is classified as 'held for sale' in accordance with SLFRS 5, it should be accounted for under SLFRS 5
- An entity is also exempt from applying the equity method in its consolidated financial statements where the following applies.
  A. It is a parent exempt from preparing consolidated financial statements under SLFRS 10, **or**

  B. If all of the following apply:
    1. The investor is a wholly owned subsidiary or it 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 investor not applying the equity method
    2. The investor's securities (debt or equity) are not publicly traded in a market (local or foreign)
    3. It is not in the process of issuing securities in public securities markets
    4. The ultimate or intermediate parent publishes consolidated financial statements that comply with International Financial Reporting Standards

- When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a **venture capital organization**, or a mutual fund, unit trust and similar entities including investment linked insurance funds, the entity may elect to measure **that investment at fair value through profit or loss in** accordance with SLFRS 9. An entity shall make this election separately for each associate or joint venture (Investment by investment basis), at initial recognition of the associate or joint venture.

Discontinuation of the equity method

An entity shall discontinue the use of the equity method **from the date when its investment ceases to be an associate or a joint venture**. The following are main two ways that an entity will usually cease to be an associate or a joint venture.

1. If the investment **becomes a subsidiary**, the entity shall account for its investment in accordance with SLFRS 3 Business Combinations and SLFRS 10.
2. If the **retained interest** in the former associate or joint venture **is a financial asset**, the entity shall measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as a financial asset in accordance with SLFRS 9.

    a. Therefore, at the date of discontinuation, an entity need to measure the total fair value gain or loss and recognize it in the **profit or loss**. It can be calculated as follows.

Fair value of any retained interest	XXX
Plus: Any proceeds from disposing of a part interest in the associate or joint venture	XXX
	XXX
Less: The carrying amount of the investment at the date the equity method was discontinued	(XXX)
Fair value gain/(loss)	**XXX/(XXX)**

Further, when an entity discontinues the use of 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 as would have been required if the investee had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognized in other comprehensive income by the investee would be reclassified to profit or loss on the disposal of the related assets or liabilities, the entity reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when the equity method is discontinued.

Same Reporting Date

If the year end difference is less than 03 months, then the group can ignore and apply the equity accounting for the existing set of separate financial statements by adjusting for significant transactions.

However, if the year-end difference is more than 03 months then the associate shall prepare another set of separate financial statements as at the reporting date of the parent for the consolidation purpose.

Uniform accounting policies

Uniform accounting policies should be applied in the financial statements of the associate and parent company. Where this is not the case, the associate's accounts are adjusted.

THE EQUITY METHOD IN THE CONSOLIDATED FINANCIAL STATEMENTS

In the consolidated statement of financial position, **'Investment in Associate'** is shown as a **non-current asset**. The amount to be shown in the consolidated statement of financial position at the reporting date is calculated as follows.

Cost of the investment/Initial Investment	XXX
Add:	
Gain on bargain purchase (if any)	XXX
Add or Less:	
Share of post-acquisition reserves (Profit and Other Comprehensive Income)	XXX
Other Adjustments (Share of unrealized profit, share of depreciation on FV gains of PPE)	XXX
Less:	
Impairment of Investment	(XXX)
Dividends Received (if this has not adjusted via share of post-acquisition reserves)	(XXX)
Carrying amount of the Investment in Associate	**XXX**

In the **consolidated statement of profit or loss and other comprehensive income**, the associate is included as **two-line** items:

- Share of profit (or loss) of associate
- Share of other comprehensive income of associate

Test Your Understanding 23 – Equity Accounting

On 01.04.2021, Purijjala Group acquired 20% of the voting shares in Abekoon Company at a cost of Rs. 300Mn, paid in cash. Abekoon made profits of Rs. 12m in the year ended 31.03.2022(which were deemed to accrue evenly throughout the year) and Rs. 25Mn in the year ended 31.03.2023. Further, on 31.03.2023 Abekoon Company has also recognized revaluation losses in other comprehensive income of Rs. 6Mn.

Required to:

1. Explain the accounting treatment in consolidated financial statements for both the year ends as per LKAS 28.
2. Prepare draft consolidated financial statements for both periods.

Losses in Associates

The group share of losses by an associate reduce the carrying amount of the associate in the consolidated statement of financial position until such time as the carrying amount is reduced to nil. After this, additional losses are recognized as a liability, to the extent that the parent has legal or constructive obligations to make or has made payments on behalf of the associate. If the associate later returns to profit, the parent resumes recognizing its share of profits only after they equal the share of losses not recognized.

Goodwill and Gain on Bargain Purchase on Associates (Allocation of cost price to net assets acquired)

As we have seen, an associate is always carried at cost when initially recognized. Despite this, on acquisition, the consideration paid is notionally allocated to the fair value of the net assets acquired.

1. Where the cost of the investment exceeds the fair value of net assets acquired **(Investment > FVINA*Invested%)**, notional goodwill exists **within the carrying amount of the Investment in Associate** in the statement of financial position. This is not recognized separately as goodwill and is not amortized. When preparing a set of consolidated financial statements, **no adjustment is required**.

2. Where the cost of the investment is less than the fair value of net assets acquired **(Investment < FVINA* Invested %)**, the difference is same like a gain on bargain purchase and it is included as an income of the group(acquirer) and will be separately added to the investment in associate value

Dr	*Investment in Associate*	*XXX*
Cr	*Consolidated Retained Earnings*	*XXX*

Test Your Understanding 24

P Invested Rs. 200,000 in 30% of equity shares of A on 01 April 2022. At the date of investment, A had a book value of net assets amounting to Rs. 500,000 and the fair values were equal to the book values.

Required to:

1. Calculate the Goodwill on investment in associate.
2. Explain the accounting treatment as per LKAS 28.

Test Your Understanding 25

P Invested Rs. 200,000 in 30% of equity shares of A on 01 April 2022. At the date of investment, A had a book value of net assets amounting to Rs. 800,000 and the fair values were equal to the book values.

Required to:

1. Calculate the Gain on Bargain Purchase on investment in associate.
2. Explain the accounting treatment as per LKAS 28.

Investment day fair value adjustments on the associate's net assets

Share of investment day fair value adjustments will be implicitly included in the Investment in Associate balance. Therefore, it is not required to separately adjust. However, **subsequent share of depreciation** shall be recognized based on those fair values.

Dr	*Consolidated Retained Earnings*	*XXX*
Cr	*Investment in Associates*	*XXX*

CONSOLIDATION ADJUSTMENTS

An associate is **not part of the Group** which is identified as a single economic entity. Therefore, when preparing a consolidated statement of financial position, the **inter-company balances shall not be eliminated**.

However, unrealized profits relating to inter-company sales and transfers of assets do require adjustment. These are referred to by LKAS 28 as upstream and downstream transactions and are dealt with as follows.

Upstream transactions	Upstream transactions are sales from the associate to a group company (parent or subsidiary).
Downstream transactions	Downstream transactions are sales from a group company (parent or subsidiary) to the associate.

Share of unrealized profits in inventory – Downstream – Seller is a group company (Parent or a subsidiary)

When a group company sell inventory to an associate, if there are any unsold inventory out of that by the end of the reporting period, the profit kept by the seller will be yet unrealized until the goods are sold to a third party. Therefore, this unrealized profit will be included in the seller's profit and in the buyer's inventory.

Therefore, in this situation, the seller's share of profit **(URP * Invested %)** which is included in consolidated retained earnings or S' post acquisition retained earnings need to be eliminated while the same profit included the buyer's share of inventory which is included in the investment in associate also need to be eliminated.

Dr	*Consolidated Retained Earnings/S' Post Acquisition RE*	*XXX*
Cr	*Investment in Associates*	*XXX*

Share of unrealized profits in inventory – Upstream – Seller is the associate

When an associate sells inventory to a group company (subsidiary or parent), if there are any unsold inventory out of that by the end of the reporting period, the profit kept by the seller will be yet unrealized until the goods are sold to a third party. Therefore, this unrealized profit will be included in the seller's profit and in the buyer's inventory.

Therefore, in this situation, the seller's share of profit **(URP * Invested %)** which is included in consolidated retained earnings need to be eliminated while the same profit included the buyer's share of inventory which is included in the consolidated inventory also need to be eliminated.

Dr	*Consolidated Retained Earnings*	*XXX*
Cr	*Consolidated Inventory*	*XXX*

Test Your Understanding 26

Polgolla Co, a parent with subsidiaries, holds 25% of the equity shares in Alwatta Co. During the year, Alwatta Co makes sales of Rs. 1,000,000 to Polgolla Co at cost plus a 25% mark-up. At the year end, Polgolla Co has all these goods still in inventories. Polgolla and its subsidiaries have a consolidated year-end inventory balance of Rs. 13m and Alwatta of Rs. 6m.

Required to:

1. Calculate the share of URP and determine the entries to adjust it in the consolidated statement of financial position.
2. Calculate the share of URP and determine the entries to adjust it in the consolidated statement of financial position if the sale was made by Polgolla co.

Impairment losses

An impairment loss is recognized when there is objective evidence that an investment in an associate is impaired. LKAS 28 provides a list of indicators that an associate may be impaired. These include:

- Significant financial difficulty of the associate
- A breach of contract, such as default, by the associate
- It is becoming probable that the associate will enter bankruptcy or other financial restructuring.

Any impairment loss in respect of an associate is recognized in accordance with LKAS 36 and reduces the carrying amount of the associate.

Dr	*Consolidated Retained Earnings*	*XXX*
Cr	*Investment in Associates*	*XXX*

Test Your Understanding 27

Below are the statements of financial position of three entities as at 31 March 2023

Statements of Financial Position **Rs'000**

	J	P	S
Non-Current Assets			
Freehold Property	1,950	1,250	500
Plant and Machinery	795	375	285
Investments	1500	-	-
Current Assets			
Inventory	575	300	265
Trade Receivables	330	290	370
Cash	50	120	20
Total Assets	**5,200**	**2,335**	**1,440**
Stated Ordinary Share Capital (Rs.1 Shares)	2,000	1,000	750
Retained Earnings	1,460	885	390
Non-current liabilities			
12% Loan stock	500	100	-
Current liabilities			
Trade Payables	680	350	300
Bank Overdraft	560	-	-
Total Equity and Liabilities	**5,200**	**2,335**	**1,440**

Additional information:

(a) J Co acquired 600,000 of the 1 million ordinary shares in P Co on 1 April 2021 for Rs. 1,000m when the retained earnings of P Co were Rs. 200m.

(b) At the date of acquisition of P Co, the fair value of its freehold property was considered to be Rs. 400m greater than its value in P Co's statement of financial position. P Co acquired the property in April 2011 and the buildings element (comprising 50% of the total value) is depreciated on cost over 50 years.

(c) J Co acquired 225,000 of the 750,000 ordinary shares in S Co on 1 April 2022 for Rs. 500m when the retained earnings of S Co were Rs. 150m.

(d) P Co manufactures a component used by both J Co and S Co. Transfers are made by P Co at cost plus 25%. J Co held Rs. 100m inventory of these components on 31 March 2023. In the same period, J Co sold goods to S Co of which S Co had Rs. 80m in inventory at 31 March 2023. J Co had marked these goods up by 25%.

(e) The goodwill in P Co is impaired and should be fully written off. An impairment loss of Rs. 92m is to be recognized on the investment in S Co.

(f) The non-controlling interest is measured at fair value. P Co shares were trading at Rs. 1,600 just prior to the acquisition by J Co.

You are required to:

1. Prepare Consolidated Statement of Financial Position as at 31.03.2023.