Grant Thornton

Technical Accounting Alert

Equity accounting, fair value adjustments and impairment

Introduction

The purpose of this alert is to discuss the adjustments required on the initial acquisition of an investment in an associate, and the effect of those adjustments on the investor's share of the associate's profit or loss (including impairment charges).

Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 12 Income taxes	AASB 112 Income Taxes
IAS 28 Investments in Associates	AASB 128 Investments in Associates
IAS 36 Impairment of Assets	AASB 136 Impairment of Assets
IFRS 3 Business Combinations	AASB 3 Business Combinations

Overview

The IAS 28 requires use of the equity accounting method of investments in associates (with some very limited exceptions). In summary, the equity method involves:

- Recording the investment at cost on acquisition; and
- Subsequently adjusting the carrying value for the investor's share of profits or losses, less any distributions received (IAS 28.11).

The share of profits or losses of the associate for this purpose will not usually be directly available from the associate's separate financial statements. This is because IAS 28 requires the investor to perform an IFRS 3 "purchase price allocation" on acquisition of its investment. In effect, equity accounting is therefore similar to accounting for business combination (even though the investment and the subsequent share of profit or loss are presented on as single items in the statement of financial position and statement of comprehensive income).

Guidance

An investor initially records an interest in an associate at cost (IAS 28.11). On acquisition, the investor should also determine the fair value of its share of the associate's identifiable assets, liabilities and contingent liabilities (IAS 28.23).

The purchase price allocation will often result in fair value adjustments to the assets and liabilities recognised by the associate where the investor effectively restates the associate's statement of financial position in the same way as an acquiree's statement of financial position is restated in a business combination. The investor:

- Revalues to fair value assets and liabilities included in the associate's statement of financial position;
- Recognises at fair value intangible assets (such as brands and customer relationships) that may not be included in the associate's statement of financial position;
- Recognises at fair value the associate's contingent liabilities; and
- Records adjustments to give effect to uniform accounting policies (IAS 28.27).

These assets, liabilities and contingent liabilities are subsumed into the overall carrying value of the investment for presentation purposes, but need to be identified and tracked for measurement purposes.

It should be noted that this exercise also includes accounting for deferred taxes - IAS 12.19. The difference between the cost of the investment and the fair value of its share of the associate's identifiable assets, liabilities and contingent liabilities is goodwill. Because the investment is recorded as a single item, goodwill and the adjustments referred to above are included within the overall net investment. However, the acquisition-date adjustments affect the investor's share of the associate's profit or loss in future periods.

In reporting results from its investments in associates, the investor needs to track consequently the values of the assets and liabilities imputed on acquisition, in order to determine the correct adjustments for depreciation, amortisation and impairment. In some cases an impairment charge may be necessary for an asset that the associate itself has not even recognised in the associate's own financial statements.

For example:

- Depreciation charges are based on the fair values of depreciable assets at the acquisition date not on the amounts recorded in the associate's own financial statements (IAS 28.23);
- Intangible assets not recognised by the associate give rise to amortisation charges (unless they have an indefinite useful life). The requirements of IAS 36 on impairment also need to be applied. Hence the investor may recognise (its share of) an impairment charge even though no charge is included in the associate's financial statements; and
- If the associate has recognised goodwill in its financial statements, any related impairment charge is excluded from the investor's share of the associate's profit or loss for equity accounting purposes.

These adjustments are necessary in order that the investor records the correct share of the associate's profit or loss in accordance with IAS 28.11. As explained in the guidance section, the purchase price allocation adjustments affect the subsequent measurement of the investor's share of the associate's profit or loss. This should be derived from the associate's financial statements, as adjusted:

- To achieve uniform accounting policies; and
- To reflect the future effect of the purchase price allocation adjustments referred to above.

One practical consequence of these requirements is that the investor may need to carry out impairment tests on certain intangibles of the associate (because the associate has not recorded them). This will require information from the associate including forward-looking information.

After applying the equity method, the investor should also consider whether there is objective evidence of impairment of its overall net investment (IAS 28.31). Any goodwill identified at acquisition is included in the overall net investment for this purpose. In evaluating the need for any additional impairment charge, the investor:

- Applies the requirements of IAS 39.58-62 to determine whether or not there is objective evidence of impairment (IAS 28.31); and
- If necessary, applies the requirements of IAS 36 to quantify any impairment loss (IAS 28.33).

Example

(The following example is intended to illustrate some of the points in this TA alert. It is not necessarily realistic or comprehensive. For the purpose of the example, tax effects are ignored).

On 1.1.X1, investor A acquires a 40% interest in entity B, for $300,000. Entity A determines that B meets the IAS 28 definition of an associate. Entity A reports in accordance with IFRS and applies accounting policies consistent with A's. At 1.1.X1, Entity B's net assets total $540,000. Entity A applies the requirements of IFRS 3 to recognise B's identifiable assets, liabilities and contingent liabilities. The book values and adjustments are summarised in the following table:

	Book value at 1.1X1	Fair value and other adjustments	Notes (see below)	Total
Property, plant and equipment (PP&E)	300	100	(a)	400
Goodwill	40	(40)	(b)	-
Other intangible assets	-	150	(c)	150
Other assets & liabilities	200	-		200
Contingent liability - litigation	-	(150)	(d)	-
Total	540	60		600
Entity A's 40% interest				240
Cost of 40% interest				300
Notional goodwill				60

Notes

a Adjustment to revalue PP&E to fair value of $400,000. The remaining useful life is assessed as 10 years, with zero residual value.

b Goodwill recognised by entity B is not an identifiable asset so is excluded from the fair value statement of financial position;

c Adjustment to recognise two brands owned by entity B: Brand X is valued at $130,000. Brand Y is valued at $20,000. The estimated useful life of both brands is 10 years.

d Adjustment to record at fair value a contingent liability in relation to a lawsuit filed against Entity B.

The accounting entry recorded on 1.1.X1 is as follows:

1.1X1 ($000s)	Debit	Credit
Investment in associate	$300	
Cash		$300

During 20X1, Entity B records a net profit of $200,000. This figure includes:

- An impairment charge of $40,000 in relation to the goodwill recorded in Entity B's statement of financial position;
- Depreciation of $30,000 in relation to PP&E; and
- A charge of $200,000 reflecting a payment to settle the lawsuit referred to in (d) above.

Also, during 20X1 Entity B's management decides to discontinue Brand Y and focus on Brand X. Entity A determines that Brand Y is fully impaired. Entity B does not make any distributions in the year.

Based on these facts, Entity A makes the following adjustments to Entity B's net profit to determine the share profit for equity accounting purposes:

1.1X1 ($000s)	Notes (see below)	$000s
Net profit as reported by Entity B		200
Adjustments:		
- Additional depreciation	(a)	(10)
- Reversal of B's goodwill impairment	(b)	40
Amortisation of Brand X	(c)	(13)
Impairment of Brand Y	(d)	(20)
Litigation settlement	(e)	150
Net profit for equity accounting purposes		347
Entity A's 40% interest		139

Notes

a Adjustment to record additional depreciation based on the fair value of Entity B's PP&E ($400,000 - $300,000) / 10 years.

b Goodwill recognised by Entity B is excluded from the fair value statement of financial position, so the impairment charge needs to be reversed for equity accounting purposes.

c Amortisation of Brand X - $130,000/10 years.

d Impairment charge of $20,000 to write-off Brand Y.

e Entity B has recorded an expense of $200,000 for the litigation settlement but the contingent liability was recorded at an amount of $150,000 in the fair value statement of financial position. This contingent liability is reversed for equity accounting purposes.

Entity A records the following entry to recognise its share of Entity B's profits:

31.12.X1 ($000s)	Debit	Credit
Investment in associate	$139	
Statement of comprehensive income (share of profit of associate)		$139

Consequently, the carrying value of the investment at 31.12.X1 becomes $439,000. If there is any objective evidence of impairment of this net investment amount, an impairment review should be undertaken. The goodwill identified at acquisition ($60,000) is included in the overall net investment for this purpose.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au