QUESTION OF THE MONTH - MAY

For many years, ABC has owned 35% of the voting shares and held a seat on the board of XYZ Company which has given ABC significant influence over XYZ Company. The other shares (65%) in XYZ Company were held by many other shareholders who all owned less than 10% of the share capital. On this basis, ABC considered XYZ Company to be an associate and has used equity accounting to account for its investment. In December 2015, PQR made an offer to buy all of the shares of XYZ Company. The offer was supported by the majority of XYZ Company's directors. ABC did not accept the offer and held on to its shares in XYZ Company. On 01st January, 2016, PQR announced that it had acquired the other 65% of the share capital of XYZ Company and immediately convened a board meeting at which three of the previous directors of XYZ Company were replaced, including the seat held by ABC.

You are required to explain how the investment in XYZ Company should be treated in the consolidated statement of profit or loss of ABC for the year ended 31st March, 2016 and the consolidated statement of financial position as at 31st March, 2016.

ANSWER

To be treated as an associate (i.e. equity accounted) an investor must have significant influence over the investee company. Significant influence is the power to participate in (but not control) the affairs of the investee. There are several ways in which significant influence is determined, the most important of which is that a holding of 20% or more of voting shares leads to 'presumed' influence. Another indicator of influence is a seat on the board of the investee. Prior to PQR offer, ABC could demonstrate both of these influences and correctly treated XYZ as an associate. LKAS 28 Investments in Associates and Joint Ventures says the 20% holding criteria gives presumed influence unless it can be clearly shown that this is not the case. After the successful offer by PQR, ABC still holds 35% of XYZ (it did not sell its shares); however, there is strong evidence that this no longer gives ABC any level of influence over XYZ. From 1 April 2015, XYZ became a subsidiary of PQR which means it can exert control over XYZ. It is difficult to see how ABC can have any influence over XYZ when PQR is exerting active control as is evidenced by ABC immediately losing its seat on the board of XYZ. Thus from 1 April 2015 to 31 December 2015, XYZ should (continue to) be equity accounted in the consolidated financial statements of ABC. At that date equity accounting should cease and instead XYZ should be treated as a (simple) financial asset equity investment. Its initial carrying amount at 1 January 2016 would be its carrying amount immediately before reclassification; subsequently it would be accounted for at fair value through profit or loss with any dividends received being treated as investment income.