Chapter 2

Accounting treatment for cross holding associates

This article aims to:

Discuss the accounting treatment for cross holding structures under Ind AS.

Introduction

Ind AS 28, *Investments in Associates and Joint Ventures* prescribes the accounting for investments in associates[1] and requirements for the application of equity method when accounting for investment in associates. Further, under Ind AS 28 an entity is presumed to have significant influence when an entity holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee.

Accounting of an associate through equity method

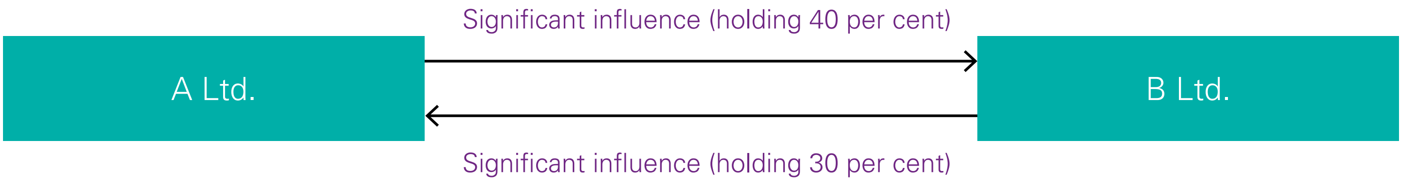
An entity with joint control of, or significant influence over an investee should account for its investment in an associate or a joint venture using the equity method except when that investment qualifies for an exemption under Ind AS. Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition.

1. Associate is an entity over which the investor has significant influence.

Cross holding

Two entities may have an ownership interest in each other that results in mutual significant influence or joint control. For example, an entity could be an investor in an associate and that investee or associate could be an investor in the entity and have significant influence over it. The situation is termed as cross holding structures.

Following illustration explains the structure.



Impact of cross holding while applying equity method

Application of equity method is complicated by cross holding structures as there is a reciprocal relationship. Further, Ind AS 28 also does not provide any specific guidance on application of equity method in such a scenario.

The Institute of Chartered Accountants of India (ICAI) issued an educational material on Ind AS 28, which provides a summary of the standard in the form of key requirements and Frequently Asked Questions (FAQs) covering certain issues expected to be encountered frequently while implementing the standard. The educational material also discusses the accounting of associates in case of cross holding structures. It discusses that Ind AS 28 provides that when an associate or joint venture has subsidiaries/associates/ joint ventures, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's/ joint venture's financial statements (including the associate's/joint venture's share of the profit or loss, other comprehensive income and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies.

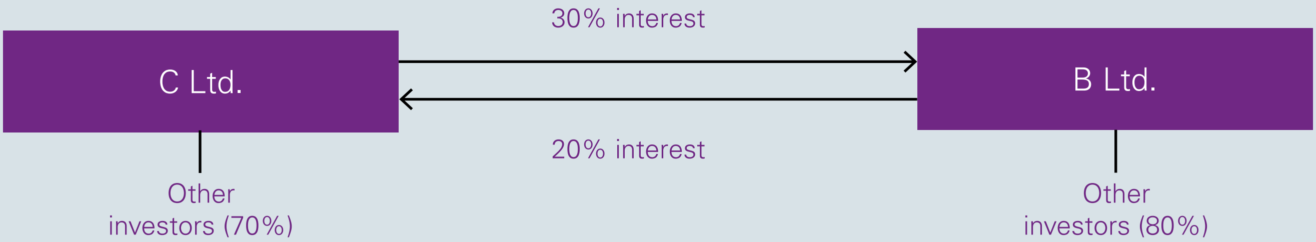
However, the cross holding structures or reciprocal interest would lead to double counting of profits. Since in case of cross holding, the comprehensive income of investor includes investor's share of post-acquisition comprehensive income of investee or associate, and the comprehensive income of investee or associate includes investee's share of post-acquisition comprehensive income of investor.

According to the educational material, in the case of reciprocal holdings, it would be appropriate to simply account for interest i.e. in investor's financial statements where the share of investor in an associate would be calculated ignoring the reciprocal interest held by associate.

The following illustration discusses the accounting of the cross holding structures using simple interest approach.

Illustration: Exclusion of cross holding interest

Company C owns 30 per cent of company B, and B owns 20 per cent of C. Each company has significant influence over the other and therefore, applies the equity method.



Other details are as follows:

	C Ltd.	B Ltd.
Trading profit (before reciprocal share)	100,000	60,000
Number of shares	20,000	10,000

Accounting issue: How would entity C Ltd. and B Ltd. account for cross holdings?

In the instant case, C's profit is dependent on B's profit and vice versa. C's profit = INR100,000 + 30 per cent of B's profit and similarly B's profit = INR60,000 + 20 per cent of C's profit. The same would apparently be leading to double counting of profit.

Therefore, considering the net approach discussed above, the profit for the period is calculated by adopting an approach of simple accounting for interest in associate i.e. ignoring the reciprocal interest held by the associate.

Profit of C Ltd. = 100,000 + 30% of 60,000 = INR118,000

Profit of B Ltd. = 60,000 + 20% of 100,000 = INR80,000

Calculation of Earnings Per Share (EPS)

For the purpose of calculating the EPS, the profits related to the reciprocal interests should be ignored. Therefore, the number of shares should also be adjusted to eliminate the reciprocal holdings to calculate EPS.

C Ltd. has effectively acquired 6 per cent of its own shares (30% x 20%), and B Ltd. has acquired 6 per cent of its own shares (20% x 30%). These shares should be treated as being equivalent to treasury shares and ignored for the purpose of the EPS calculation.

	C Ltd.	B Ltd.
Total number of shares	20,000	10,000
Number of shares after elimination	18,800 20000*(100%-6%)	9,400 10,000*(100%-6%)
Profits	INR118,000	INR80,000
EPS	INR6.28 (118,000/18,800)	INR8.5 (80,000/9,400)

Conclusion

The company should exercise significant judgement and consider all the facts and circumstances while determining the interest in another associate. The simple interest approach discussed in educational material is in line with the consolidation principles prescribed under Ind AS 110 which provides that the income arising on investment held by a subsidiary in a parent should be eliminated in consolidated financial statements.

Internationally, under IFRS, cross holding accounting is based on effective ownership interest approach. Under the effective ownership approach, an investor determines its share of comprehensive income of an investee on the basis of the investor's effective interest in the investee. The effect of the reciprocal interests is incorporated into the investee's financial statements through the investee's own equity accounting - i.e. the investee's comprehensive income would already include the equity pick-up for its own equity interest in the investor.