

Accounts of Holding Companies

Introduction

An important development of recent times in the business world is the combining of independent business units into a group or an economic unit. A company may acquire either the whole or majority of shares of another company so as to have a controlling interest in such a company or companies. The controlling company is known as Holding or Parent Company and the company controlled is known as Subsidiary Company.

Meaning of Holding Company

Section 4 of the Companies Act, 1956 defines a holding company. According to this section, one company can become the holding company of another in any of the following three ways:

1. By holding more than 50% of nominal value of the equity shares of the other company i.e. the holding company holds the majority of voting power in the subsidiary company.
2. By controlling the composition of the Board of Directors of the other company so that the holding company is able to appoint or remove the directors of the subsidiary company.
3. By controlling a holding company which controls another subsidiary or subsidiaries. For example, if B Ltd is a Subsidiary of C Ltd & C Ltd is a subsidiary of A Ltd then B Ltd is also deemed to be a subsidiary of A Ltd.

Purpose

The purpose of getting the control over another company may be to gain advantages such as:-

1. To eliminate of competition.
2. To enjoy the economies of large scale of production.
3. To achieve an assured market for the product of the company.
4. To ensure a smooth supply of raw materials.
- 5.

Advantages of Holding Company: Following are the important advantages of holding company:

a) Easy Formation: The holding company can be formed very easily. There is no legal formality. Any company may purchase the majority shares from stock exchange and can become holding company.

b) Large Business: A holding company can collect the capital and expand the business on large scale.

c) Foreign Capital: The holding company may also attract the foreign capital for the expansion of a business.

d) A Stable Combination: The holding company is a very stable form of business organization. Its life is not affected by the disagreement of subsidiary company.

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e) Goodwill: When the goodwill of the holding company is established in the market, it also improves the goodwill of its subsidiary company before the public.

f) Separate Position: The subsidiary companies can maintain their separate position under this system. They do not lose their identity.

g) Control on Production: A holding company can check the production and adjusts the supply according to the demand. So over production can not take place.

Disadvantages or Defects of Holding Company: Following are the main defects of the holding company:

a) Problem of Monopoly: A holding company tries to create monopoly over the market. Monopoly is always against the public interest. It fixes higher prices and consumer suffers a loss.

b) Unequal Distribution of Wealth: Due to holding companies wealth goes in few hands and society is divided into two classes, rich and poor. Rich class enjoys all the amenities of life while poor class faces poverty and hunger.

c) Costly Management: A holding company spends a lot of money on the officers and offices. All the units are managed by the central authority. So it is costly to maintain the proper control on large number subsidiary companies.

d) Minority Interest Ignored: The interest of the minority shareholders is ignored and the members of the holding company dispose of every resolution for their own interest.

e) Misuse of Funds: The directors of the company enjoy unlimited powers and they take undue advantages. They misuse the funds also.

f) Over Capitalization: There is always a danger of over capitalization in the holding companies. It is very harmful for both the companies.

g) False Reports: Generally the directors of the company present false reports about the company's financial position. The true condition of the company no body knows, and due to this sometimes creditors suffer a loss.

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Meaning of “subsidiary Company”

A company is a “subsidiary” of another company, its “holding company”, if that other company—

- a) holds a majority of the voting rights in it, or
- b) is a member of it and has the right to appoint or remove a majority of its board of directors, or
- c) is a member of it and controls alone, pursuant to an agreement with other members, a majority of the voting rights in it, or if it is a subsidiary of a company that is itself a subsidiary of that other company.

Accounts

Under section 212 of the Companies Act, 1956 the following must be attached to the Balance Sheet of a holding company:

1. A copy of the Balance Sheet of the Subsidiary or Subsidiaries.
2. A copy of the Profit & Loss Account.
3. A copy of the Report of its Board of Directors.
4. A copy of the Report of the Auditors.
 - a. A statement of the holding company’s interest in the subsidiary.
 - b. The profits of the subsidiary as far as they concern the holding company.

Consolidation of Balance Sheet & Profit & Loss Account

In India, the law does not compel a holding company to prepare a consolidated Balance Sheet & Profit & Loss Account. It is only for convenience that these statements are prepared.

Shareholders of a holding company are interested in knowing the affairs of the subsidiary company as part of their money given to the holding company is invested in subsidiary company. So it becomes safe for directors of the holding company to disclose to the shareholders of the holding company the extent to which they are entitled to the net assets of the subsidiary company. By way of consolidated Balance Sheet, the investments of the holding company in the subsidiary company are replaced by assets.

Consolidation of Balance Sheet & Profit & Loss Account means the combining of the separate Balance Sheet & the separate Profit & Loss Accounts of the Holding company & its subsidiary company or companies into Single Balance Sheet & a Single Profit & Loss Account.

The purpose of a Consolidated Balance Sheet & Profit & Loss Account is to show the financial position & Operating results of a group consisting of a holding company & one or more subsidiaries. The consolidated statements are reports of notional accounting entity which subsist on the view that the holding & subsidiary companies are to be treated as one economic unit. The Financial position & Operating results reported through the consolidated statements are portrayed from the interest of the members of the holding company.

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Wholly owned subsidiary company

When all the shares of a subsidiary company are held or owned by the holding company, the subsidiary company is known as a wholly owned subsidiary company.

Partly owned subsidiary company

When a majority of shares, but not all the shares of a subsidiary company are owned by the holding company, the subsidiary company is known as a partly owned subsidiary company.

Elimination of Investments

Where a holding company holds all the shares of a subsidiary or its assets belong to the holding company, which is also liable for all its debts. In other words, the investment by the holding company in the shares of subsidiary company represents excess of assets over liabilities or capital.

While preparing the consolidated balance sheet it is necessary to eliminate investment & its complement of the paid up capital of subsidiary company. Holding company's investment which is subsidiary's capital, which in turn is equal to the excess of assets over liabilities of the subsidiary, become internal items in the consolidated balance sheet. Hence, the two are cancelled against each other & substituted by the assets & liabilities of the subsidiary.

Pre Acquisition Period

Pre acquisition period is the period which falls on or before the date on which the shares of the subsidiary company are acquired by the holding company.

Post Acquisition Period

Post acquisition period is the period which falls on after the date on which the shares of the subsidiary company are acquired by the holding company.

Profits

The profit of the subsidiary may be divided into

1. Capital profit
2. Revenue profit

Pre & Post Acquisition of Profits

a. General Reserve & Profit & Loss Account (credit balance) appearing in the books of the subsidiary company on the date of acquisition are treated as pre – acquisition profits. Since, they were not earned by the holding company in the ordinary course of business they are capitalized & set off against the purchase price of the shares.

b. A pre – acquisition loss appearing in the books of the subsidiary company is treated as a capital loss & debited to goodwill account.

c. Post acquisition profits or losses are those that are made or suffered by a subsidiary company after its shares have been purchased by the holding company. Revenue profits are

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added to the profits of the holding company if it acquires all the shares of the subsidiary company or to extent of its share holding in the subsidiary company. A post acquisition loss is treated as a revenue loss & deducted from the profits of the holding company.

d. If the date of acquisition is during the course of the year it becomes necessary to make an estimate of pre acquisition & post acquisition periods on time basis so as to apportion profits.

Cost of Control

In practice the holding company may pay more or less than the net worth of the subsidiary company. If the holding company feels that a company the shares of which it wants to acquire enjoys considerable reputation or exceptional favourable factor it may pay more than the paid up value of shares or net assets.

The excess of acquisition price over net assets represents goodwill or cost of control. If on the other hand the acquisition price is less than the paid up value of shares the difference is again to the holding company & is known as capital reserve.

Minority Interest

When some of the shares in the subsidiary are held by outside shareholders they will be entitled to a proportionate share in the assets and liabilities of that company. The share of the outsider in the subsidiary is called minority interest.

In the consolidated balance sheet all the assets and liabilities of the subsidiary are consolidated with assets and liabilities of the holding company and the minority interest representing the interest of the outsider in the subsidiary is shown as a liability.

Revaluation of Assets and Liabilities

At the time of acquiring shares in a subsidiary it is usual for the holding company to revalue the assets and liabilities of the subsidiary in order to arrive at a fair price to be paid for the shares.

If the altered values are not taken in the books of subsidiary it is necessary to bring the assets and liabilities into the consolidated balance sheet at the altered values. The difference between the book values and revised values should be adjusted after ascertaining the share of the outsiders. Where the assets are shown in the consolidated balance sheet at the increased values depreciation provision should be increased and such increase should be deducted from capital reserve and minority interest.

If on the other hand the assets are brought in at reduced value depreciation value should be reduced and such reduction should be added to capital reserve and minority interest.

Treatment of Unrealized Profits

An unrealized inter-company profits exist where the company still holds (at the date of consolidation) stocks sold to it by the other company at a profit.

It is considered that only the holding company share of unrealized profit should be eliminated since for the minority shareholders the profit is nothing but a realized profit. Stock reserve is created whether the goods are sold by the holding company to the subsidiary and vice

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versa. The amount of unrealized profit (stock reserve) is deducted from the stock on the asset side and also the profit and loss account on the liability side of the consolidated balance sheet.

Example: A subsidiary sells goods to the holding company goods worth Rs 30,000 on which the subsidiary company made 20% profit on selling price (holding company share holds 3000 out of 4000 shares)

Unrealized profit = 20% of 30,000 = 6,000

Holding company's share = $\frac{3}{4} \times 6,000 = 4,500$.

Inter-Company Balances

1. Internal Debts

When loans are advanced to the subsidiary company by the holding and vice versa the same will appear on the asset side of the lending company's balance sheet and on the liability side of the borrowing company's balance sheet.

These being inter-company items they should be eliminated from the consolidated balance sheet.

2. Bills of Exchange

Bills drawn by the holding company on its subsidiary and vice versa appearing as bills payable in one balance sheet and bills receivables on the other, cancel each other. However bills discounted cannot get cancelled because of the liability in respect of bills payable by the accepting company and a contingent liability in the company getting the bills discounted.

a. The company discounting the bill will include the proceeds of the bills in its bank balance and will appear as a note to show the contingent liability.

b. In the consolidated balance sheet the total of bills discounted appear as bills payable representing actual liabilities.

3. Debentures

Debentures issued by one of the companies in the group and held as investment by another in the same group gets cancelled in the consolidated balance sheet and should be eliminated.

4. Contingent Liability

Contingent liabilities which may or may not materialize into liabilities are shown in the usual way by appending a footnote in the individual balance sheet. For the purpose of consolidation the treatment depends upon whether they are internal or external.

External contingent liability between the company in the group and a third party continue to appear by way footnote.

Internal contingent liability between holding and subsidiary are eliminated without being shown in the consolidated balance sheet.

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Dividends paid by Subsidiary Company: (no adjustments need be made in the books of subsidiary company)

Books of Holding Company

1. If the dividends has been paid out of pre-acquisition profits the dividends should be credited by the holding company to investment account but not profit and loss account.
2. On the other hand if the holding company has credited the dividend to profit and loss account then the dividend should be debited to profit and loss account and credited to the investment account.
3. If the dividend has been paid by subsidiary company out of post - acquisition profits the same should be credited by the holding company to its profit and loss account. If it has already credited the dividend to profit and loss account then no adjustment is required.

Dividends declared by the subsidiary company but not paid will appear as a liability in the balance sheet of the subsidiary company. In the consolidated balance sheet the proportion of unpaid dividend attributable to the holding company will be deducted from liability of subsidiary company & the balance payable to the outside shareholders will appear as a liability of the group.

Any interim dividend paid during the accounting period by the subsidiary company to the holding company should be added to the balance of profit & loss account of the holding company & deducted from the balance of profit & loss account of the subsidiary company if the adjustments have not taken place.

Bonus Shares

When a company issues bonus shares out of its accumulated profits it is necessary to distinguish between pre & post acquisition profits utilized for this purpose. In case bonus shares are issued out of pre – acquisition profits no adjustments are necessary for preparing the consolidated balance sheet because in such a case the holding company's share of such profits gets reduced & the paid up value of the shares held by it will increase. As such the amount of goodwill remains the same.

Bonus shares issued out of post acquisition profits will reduce the holding company's share in revenue profits & increase the paid up value of the shares held. Consequently, the amount of goodwill gets reduced.