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CONSOLIDATED STATEMENTS

by

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CHAPTER I

INTRODUCTION

Consolidated statements for holding company systems came into general use in the United States long before adequate attention had been devoted to the problems and principles involved. Although many attempts have since been made to establish a sounder basis for these statements, an extensive investigation of the subject will serve to integrate the procedures and clarify the results. After the purpose of the study has been defined, it will be necessary at the outset to determine the position of these combined statements in the present-day economy, to discover the nature of the need for the statements and the form the statements must take to satisfy this need, to state the basic assumption of consolidation, to consider the general accounting principles which govern the preparation, and to illustrate briefly the consolidation procedures.

Purpose and Scope of the Study

It is not the purpose of this study to advocate radical changes in the preparation and form of consolidated statements. It is felt that there is a much greater need for a comprehensive treatment of the problems based upon a few sound and consistently applied general principles. The changes proposed herein result from the attempt to integrate the procedures and bring them into harmony with general accounting principles.

Most of the writers in the field of consolidated statements have considered the case of outside holdings of shares of controlled corporations, but their main concern has been with affiliations in which the holding

company possesses all of the residual shares of the controlled companies.¹ Because some unique accounting problems are encountered whenever there is an outside or minority interest in a controlled company, and because all of the problems found in total ownership cases are also present in incomplete ownership cases, the investigation will be shortened and there will be greater assurance of completeness if it is assumed that a minority interest exists in all cases.

Instead of insisting upon establishing values consistent with the purchase price of the controlling interest, accountants have been inclined to use the book values of the controlled corporation and to account for the difference in some simplified manner. The possibilities of revising values and the results of such revisions have never been adequately explored although most writers seem to agree that revision is desirable if practical.² The attempt has here been made to trace the effects of revision of value through all of the consolidation procedures.

Many other matters require attention. In some instances sound and desirable procedures have been adopted for apparently inadequate reasons. Investigation of the underlying reasons for these procedures may lead to the development of a more consistent general theory of consolidation. Persisting conflicts of ideas as to the basic principles and procedures and the tendency of accountants in this field to neglect

¹A. W. Wyon, "Holding and Subsidiary Companies," Accountant, LXXXIX, 222, Aug. 5, 1933, investigates three cases including the two extremes and one in the middle ground which includes voting power ample for most purposes.

²"May I say that I entirely agree, and believe most accountants would agree, with the view which he (Stempf) expresses in favor of the principle of effective cost, ..." G. O. May, correspondence, The Journal of Accountancy, LXIII, 66, Jan., 1937.

certain problems make it necessary to consider all phases of the preparation of consolidated statements from the time the holding company is established.

Terminology

Consolidated statements consist of a balance sheet, an income statement, and supporting schedules designed to show the ownership area of a holding company system by combining the data of the individual statements of the affiliated corporations after the claims and transactions that fall entirely within this enlarged area have been eliminated. Such statements have been proposed and used for other oblique forms of ownership and control, such as joint stock ownership, management agreements, comprehensive leaseholds, and several other cases,³ but it may be well to limit the design to the holding company case to make sure that the statements meet the specific needs.⁴

A company holding a majority of the voting shares of a second company for the purpose of controlling the actions of the second company is called a parent company or a holding company, and the second company, owned and controlled by the first, is called a subsidiary company. The term holding company is sometimes used to refer to a company engaged in no other activities than owning shares, and the term parent company to

³For a treatment advocating the inclusion of all such devices including leases see, W. H. S. Stevens, System and Consolidated Reports for Steam Railways, Interstate Commerce Commission, July 1, 1937.

⁴"If the control lies in one of the units, as in the case of the controlling-company-subsidary relationship, the statement is a 'consolidated' statement; if the control lies elsewhere, the statement may be called a 'group' statement." E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 63, March, 1938.

refer to a combination holding and operating company.⁵ This is not a particularly useful differentiation and is not universally adhered to by the writers.

History of Consolidated Statements

The rapid expansion of the area and population of the United States and the development of production and transportation facilities have brought about a comparable expansion of business enterprise. The trust device was an early attempt at a solution of apparently excessive competition but it tended to go too far. With the passage of the Sherman Act of 1890, monopolistic possibilities of trusts were largely eliminated. In 1893,⁶ New Jersey passed enabling legislation to permit corporations to own shares of other corporations for purposes of control. Other states followed suit with the apparent intention of developing a system which, by evading the Sherman Act, would permit combinations in restraint of trade. There appeared to be considerable doubt at the time that holding companies could form combinations for purposes forbidden to trusts, but it was not until the Northern Securities case in 1904,⁷ confirmed by the Standard Oil case in 1911,⁸ and later further refined by the Clayton Act of 1914,⁹ that the holding company proved unable to accomplish the purpose

⁵Ibid., p. 64

⁶"In 1888 the legislature of New Jersey permitted corporations chartered in New Jersey to hold stocks of other corporations. ... Finally in 1893 the legislation was so broadened as to attract nationwide interest." A. S. Dewing, Financial Policy of Corporations, note q, p. 913, N. Y., 1941.

⁷193 U. S. 197 (1904)

⁸221 U. S. 1 (1911)

⁹"That no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock ... of another corporation ... where the effect of such acquisition may be to substantially lessen competition ..." Clayton Act, Sec. 7, passed Oct. 15, 1914.

of its original design.

The early combinations had demonstrated, however, that there were advantages other than control of pricing in such combinations as the holding company. Large-scale production economies explain much of the expansion and combination that occurred toward the end of the last century and the early part of the present.¹⁰ Some of the current emphasis seems to be on economies of administration and distribution.¹¹

At the turn of the century U. S. Steel started the struggle to find a more adequate basis for reporting the relationships of its subsidiary companies.¹² It was early recognized, as A. Lowes Dickinson pointed out in 1904,¹³ that individual reports of a holding company group could not be adapted to show the real position of the ownership. Added support for the use of consolidated statements developed in 1917 when the income tax authorities required these statements for tax purposes.¹⁴ Later the use of consolidated tax returns became optional and limited to substantial ownership of the voting stock. In the Roosevelt Era ,

¹⁰J. C. Bonbright and G. C. Means, The Holding Company, p. 75, N. Y., 1932.

¹¹B. C. Milner, "Do Consolidations Result in Reduction of Distribution Expense?" Bulletin of the Taylor Society, XV, 86, Apr., 1930.

¹²Annual Reports, see also R. S. Claire, "Evolution of Corporate Reports," The Journal of Accountancy, LXXIX, 47, Jan., 1945.

¹³"Under such conditions it is submitted that no statement of earnings can be considered correct which does not show in one account the profits or losses of the whole group of companies, irrespective of whether dividends have or have not been declared thereby." As quoted by P. F. Brundage, Contemporary Accounting, ch. 5, p. 1, N. Y., 1945.

¹⁴See A. A. Ballantine, "The Corporation and the Income Tax," Harvard Business Review, XXII, 277, Spring, 1944.

combinations were looked upon with suspicion, and consolidated statements were first restricted and then forbidden for tax purposes. The excess profits tax adopted to finance the war made it necessary to reintroduce the consolidated tax return provisions. Under the Securities Act of 1933 and the Securities Exchange Act of 1934¹⁵ the Securities and Exchange Commission was given the power to require consolidated statements for purposes of the registration of new security issues and for the periodic reports required for securities listed on exchanges.¹⁶ The Commission chose to require the use of consolidated statements. It is perhaps characteristic of the 1930's that while one governmental agency questioned the validity of consolidated statements another governmental agency required the use of these statements.

Need for Consolidated Statements

Demonstration that there are advantages in holding company systems and that holding company systems exist in important numbers, together with strong indications that ordinary reporting devices cannot adequately reflect the special conditions, must lead to the conclusion that a special reporting device, consolidated statements, is needed.

To a greater or lesser degree the holding company device can accomplish all of the purposes of any other combination technique. There are several advantages peculiar to the holding company, however, which arise from the possibility of continuing the individual corporations at the same time that the activities of the several affiliated companies are co-ordinated. Subsidiaries are often formed to avoid the special

¹⁵ Securities Act of 1933, Sec. 19(a); Securities Exchange Act of 1934, Sec. 13(b).

¹⁶ New York Stock Exchange, "Application for Original Listing of Stock - General," p. 6; "Application for Original Listing of Bonds," p. 6; "Application Subsequent to Original Listing," p. 8.

restrictions and taxes invoked against corporations organized outside of the state or country of their operations. Since the parent-subsidary relationship is particularly adaptable to federated organizational systems, it may be useful in those cases in which loose control by the top level of management is desirable.¹⁷ It is possible to pyramid control by means of holding companies and extend trading on the equity beyond the range of a single company.¹⁸ The maintenance of the separate companies may enable the top company to compartmentalize potential losses from new and risky endeavors, to participate in the use of certain non-transferable franchises, to insure that favorable public or employee relations will not be jeopardized through a change in the organization, to bring about combined operations with a firm when a merger is blocked by a minority of the stockholders of that firm, and to engage in certain activities (such as banking) which are limited to corporations engaged in no other lines of business. Some income tax savings are possible in this type of organization although the present rules regarding the carry-over and carry-back of losses have partially eliminated the old advantages of the utilization of the losses of one company to offset the profits of another.

The best and really the only statistical analysis of the relative importance of parent and subsidiary companies precedes the war

¹⁷"Although decentralization could undoubtedly be accomplished by other means, the holding company is perhaps the most effective instrument for bringing it about." J. C. Bonbright and G. C. Means, "Holding companies - United States," Encyclopedia of the Social Sciences, VII, 406, N. Y., 1932.

¹⁸"The owner of a majority of the stock of the company at the apex of a pyramid can have almost as complete control of the entire property as a sole owner even though his ownership interest is less than one percent of the whole." A. A. Berle and G. C. Means, The Modern Corporation and Private Property, p. 73, N. Y., 1932.

years but demonstrates that there were important numbers of such companies. If there is assurance that there have been no business of tax changes which would serve to make the device less useful, the point is sufficiently established. Table I, accompanying, shows that 1,147 of 1,739 registered companies, or approximately 66 percent, were found to have subsidiaries.

TABLE I
GENERAL SURVEY OF SUBSIDIARIES BY ASSET SIZE GROUPS OF REGISTRANTS
(Covering the fiscal year 1937)¹⁹

Asset Size Groups (millions of dollars)	Total	With No Subsidiaries		With Subsidiaries	
		Number	Percentage	Number	Percentage
500 and over	29	0	0	29	100
200 to under 500	38	0	0	38	100
100 to under 200	56	2	4	54	96
50 to under 100	79	3	4	76	96
20 to under 50	190	18	9	172	91
10 to under 20	218	30	14	188	86
5 to under 10	258	63	24	195	76
3 to under 5	209	76	36	133	64
1 to under 3	357	167	47	190	53
Under 1	300	228	76	72	24
Unknown	5	5	100	0	0
Total	1,739	592	34	1,147	66

It is worth-while to note that the proportion of subsidiaries decreases materially as the registrants become smaller until the proportion reaches a low of 24 percent. Since most of the large companies are registrants, it is certain that the over-all percentage of subsidiaries is much less than 66 percent. Nevertheless, it can be said that the situation exists in enough cases to justify considerable attention to the matter of

¹⁹Adapted from Securities and Exchange Commission, Statistics of American Listed Corporations, Part I, p. 162, Dec., 1940.

portraying the relationship. In view of the fact that the war years have brought increased recognition of the interdependence of companies and the permissive use of consolidated tax returns, it is not likely that the above proportions have decreased.²⁰

Attempts have been made, particularly in England, to adapt individual company statements in order to show the position and activities that affect those interested in the holding company. If the investment in the subsidiary is recorded at cost, the technical legal position will be shown - and it is important that this position be shown,²¹ but the current position of the ownership will not be revealed. With a large part of the securities in the hands of the parent company, market value cannot be very meaningful. Such a value will never indicate the price at which large blocks of shares can be sold.²² Cost adjusted for the parent's share of the subsidiary's gains or losses might be useful. The last alternative, however, cannot reveal the essential features of consolidation without transforming the parent company statements into consolidated statements.

Care must be taken, in view of the recent case of Cintas vs. American Car and Foundry,²³ to give adequate attention to the parent company as a separate legal unit. Earnings of a subsidiary are not available to the parent company until dividend declarations by the

²⁰Bonbright and Means, op. cit., p. 64.

²¹M. Moonitz, The Entity Theory of Consolidated Statements, p. 52-3. footnote by W. A. Paton, American Accounting Association, monograph no. 4, Chicago, 1944.

²²W. T. Sunley and W. J. Carter, Corporation Accounting, p. 291, N. Y., 1944.

²³131 N. J. Eq. 419 (1942)

subsidiary have made them available.²⁴ The investment position must be shown. If the parent company reports are devoted to this purpose, there must be a supplement which will show the ownership position in order to avoid the situation described by Arthur Chamberlain, Chairman of Tube Investment Ltd.:

We do not bring into the balance sheet the whole of the profits our activities have created; we bring in only just so much as we require to pay the dividends we recommend, and to place to general reserve, or add to the carry-forward, so much as we consider will make a pretty balance sheet.²⁵

If, as Paton says, "Accounting strives to measure economic forces in financial terms and communicate the results of such measurement to interested parties,"²⁶ the reports to stockholders should consist of the individual statements of all important members of the affiliated group as well as consolidated statements designed to show the over-all economic situation.

The Consolidation Assumption

Consolidated statements are designed to reveal essential information not clearly displayed in individual statements. When assets

²⁴"In 1925 Western Pacific Railroad Corporation ... went to the extraordinary lengths of donating the sum of \$1,500,000 to the operating company, and it immediately took the same money back as a dividend from its subsidiary. The donation it charged against its surplus; the receipt of the same money as dividends it reported as earnings. In this devious fashion it was able to report \$5 'earned' upon its common stock, when in fact the applicable earnings were only about \$2 per share." G. Graham and D. L. Dodd, Security Analysis, p. 440, N. Y., 1940.

²⁵As quoted in Accountant, XCIV, 285, by H. Morgan, Feb. 22, 1936. See also Berle and Means, op. cit., p. 203.

²⁶W. A. Paton, "Recent and Prospective Developments in Accounting Theory," p. 1, Harvard University Graduate School of Business Administration, Bureau of Business Research, Boston, 1940.

are contributed to a subsidiary and those assets are controlled by the contributor in such a manner that property rights, although restricted, still reside with the contributor, statements which show the essential ownership and the claims to which this ownership is subject should be prepared.²⁷ By assuming that the parent company and the subsidiaries constitute one compound corporation, the accountant can construct statements to display the underlying conditions while maintaining the maximum amount of legal reality.

Unfortunately the placing of all of the consolidated assets opposite the consolidated claims may lead to the erroneous conclusion that such assets form a common pool of values available to meet the claims against the group. The debt of a subsidiary, in the presence of good faith, runs only against the assets of the subsidiary but takes precedence over the parent company debt with respect to those assets. On this account, consolidated statements must be properly annotated to warn the readers against making unwarranted assumptions.²⁸

The basic assumption necessary to the preparation of consolidated statements for a holding company group is that purchase of a controlling interest in a company constitutes purchase of the business of the company. The assets given up in the purchase are thus supplanted by the assets of the subsidiary and the subsidiary's debt is added to the

²⁷H. A. Finney, "Students Department," The Journal of Accountancy, XXXIII, 139, Feb., 1922.

²⁸"The limitations of consolidated financial statements should be recognized. The status of bondholders and other creditors and the respective assets against which their claims rank may not be shown, and thus consolidated statements may be inadequate unless accompanied by additional statements." American Institute of Accountants, Examination of Financial Statements, p. 6, N. Y., 1936.

general picture. Any intercompany claims or other relationships will offset themselves and will be eliminated to present the relationships of the group to the outside world.

Accounting Standards

Little reliance can be placed upon consolidated statements unless the individual statements upon which they are based have been prepared according to uniform basic principles and unless the consolidation procedures are consistent with these rules. Certain accounting principles must be modified slightly before they may be used in the consolidation. Any rules adopted should conform to Paton's formulation of the purpose of accounting:

Briefly, this purpose is that of compiling and interpreting the financial data of specific business entities in such manner as to furnish a sound guide to action by management, investors, governmental agencies, and other appropriately interested parties, and to secure equitable determinations with respect to the parties, in the light of prevailing standards of law and business practice and with due regard to long-run as well as short-run considerations.²⁹

Legal Framework of Accounting

Business does not exist in a vacuum but in a society that subjects it to certain regulations. When the financial implications of an item turns, as it often does, upon the legal rules applicable thereto, the legal position should be clearly indicated. On the other hand, it is undesirable to confuse the reader by extended or complicated portrayals of legal minutia.³⁰

Legal aspects affecting the preparation of consolidated

²⁹"Cost and Value in Accounting," The Journal of Accountancy, LXXI, 195, March, 1946.

³⁰W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, p. 4, American Accounting Association, monograph no. 3, Chicago, 1940.

statements center around the corporate entity. Dewing offers a rather concise description of the main ideas:

Legally the corporation embodies four ideas. It is the formal expression of an agreement of two or more persons; it receives the creative touch of a sovereign power ... ; it has, in itself and apart from its members, such reality that it can acquire and hold money and property, enter into contracts, sue and be sued both in law and equity, and otherwise assume the responsibilities of a property-owning human being; and finally, it has a length of life not subject to the mortal limitations of human beings.³¹

While the corporation is an association of human beings, this association is a distinct legal unit and the members cannot identify themselves directly with the corporation.³²

The legal premise that the property of the corporate entity is not the property of the stockholders³³ makes it desirable to segregate items pertaining to a corporation. If this segregation is neglected in a holding company situation, the court may choose not to distinguish the property when settling claims.³⁴ A corporation can lawfully give up property to its stockholders only by following procedures set up to protect creditors and others whose claims are restricted to the corporate entity. In order to preserve the integrity of the resources for all those having such restricted claims two things are necessary - a separate system of accounts for each corporation to give a complete history of all

³¹Dewing, op. cit., p. 4.

³²Notes entitled, "Disregarding Separate Corporate Entities to Preserve an Integrated Economic Structure," Columbia Law Review, XLVII, 110, Jan., 1947.

³³"The stockholders in their individual capacity cannot bind the corporation or transfer its property. Nor are they personally liable upon its debts or contracts." H. W. Ballantine, Corporations, p. 19, Chicago, 1927.

³⁴Consolidated Rock Co. v. DuBois, 312 U. S. 510 at 523, (1941).

properties and activities,³⁵ and safeguards to insure that all transactions are conducted on an arm's-length basis.³⁶ By adhering to these two requirements and by making the information available to interested parties in individual corporate statements, accountants can construct the consolidated statements to show the broader economic aspects rather than the exact contractual positions of the interested parties.

Accounting for a Going-Concern

As a corollary to the idea of the separation of the property rights from the owners is the idea that properties are to continue to be separated as long as their use in the enterprise proves advantageous. There are two phases to this idea. First, it follows that the assets of the business will become available to the owners only as such assets exceed business needs. In normal conditions an amount recovered in excess of cost can be considered available for expansion or distribution to the owners, and consequently cost as a measure of effort is generally considered a sound basis of valuation.³⁷ Second, it follows that all claims against the business, in the absence of knowledge to the contrary, will be carried to the contract maturity, and may best be recorded at the amount of the commitment plus the accrued contractual share of earnings where such share can be determined. Assets abandoned or in process of

³⁵W. H. Anderson, Limitations of the Corporate Entity, p. 102, St. Louis, 1931.

³⁶Kohler, op. cit., p. 68.

A. A. Berle, Studies in the Law of Corporation Finance, p. 174, Chicago, 1928.

³⁷"One purpose may require assets to be priced or valued in order that an immediate decision as to rights may be reached; the other purpose, that of placing business effort and accomplishment in contrast, is more effectively served by a systematic tracing of costs." Paton and Littleton, op. cit., p. 11.

abandonment or disposal as well as equities in process of retirement are not parts of a going-concern and should be valued on a liquidation basis.³⁸

The merger assumption used for consolidated statement purposes carries with it the idea that the individual companies cease to have independent lives but become a part of a new concern. Although the individual statements can be continued on the same basis, there is something to be said for a revision of values to conform to the new conditions.

Objectivity as a Standard

Accounting statements are used for a number of different purposes and in each use modifications and interpretations by the reader may be necessary.³⁹ Statements will be more adaptable if they are made as objective as possible.⁴⁰ The thesis that the best measure of value is that arrived at as a result of an arm's-length purchase or sale is based on recording what did happen rather than what might have happened. But cost should not be blindly adhered to as Paton points out:

In all questionable situations the accountant should take such steps as are deemed necessary or feasible to test the validity of the contract terms as a measure of value at the date of transfer, and where he is convinced that the nominal cost is not reasonably indicative of fair value he should encourage proper adjustment and - at least - insist upon clear disclosure of the limitations of the cost data.⁴¹

³⁸Moonitz, op.cit., p. 41.

³⁹Paton and Littleton, op. cit., p. 11.

⁴⁰"In this connection it should be emphasized that accounting does not set up a rigid framework of procedure which must be followed regardless of the circumstances; accounting, to achieve maximum usefulness, must conform to the circumstances. This does not mean, of course, that accounting should be subservient to the opinions of particular individuals who are unwilling to permit objective conditions to control." Paton, "Cost and Value in Accounting," op. cit., p. 195.

⁴¹Ibid., p. 193.

Nevertheless, the general rule is that assets should be valued at cost in the first instance and should be continued on a cost basis until cost can be demonstrated to be materially and persistently incorrect.⁴² When property other than cash is given in exchange for the new property acquired, the cost thesis requires that the fair value of the property given be treated as the cost of the property acquired. If stock is issued for property, there is no exchange but a contribution by an owner to the enterprise and the fair value of the property must govern.⁴³

There would be undeniable advantages in recognizing profits in the periods in which they are earned. This, however, would involve many estimates and would often lead to erroneous conclusions. It is probably more desirable in most cases to recognize revenue in the period in which it is objectively realized and to determine the profit by offsetting the costs of obtaining the revenue. Passage of title to goods or the giving up of possession are the usual guides as to when revenue has been objectively realized.⁴⁴

Three aspects of objectivity are particularly applicable to the problems found in consolidation situations. Where the two parties to a deal have related interests, which is true in all transactions between the parent and the subsidiary, there is a possibility that cost may be out of line with current value. Since there are always other parties involved in such cases, attention should be paid to completing all deals

⁴²Ibid.

⁴³Ibid., p. 194

⁴⁴"One's own judgment of added utility is not conclusive; the test comes when a sale is made." Paton and Littleton, op. cit., p. 14.

at fair value.⁴⁵ Purchases and sales between affiliated companies should be based on fair values, but profits arising therefrom should not be considered to be realized if there is a possibility that later events will not bear out the amount of the supposed profits. A price paid in excess of the value of tangible assets acquired can be considered to be cost of intangible assets, if it is reasonable to suppose that tangible values exist, and the cost of intangibles should be assigned as a cost of revenues to the extent that it is instrumental in producing revenues.⁴⁶

The Accounting Equation

There are times when the accountant is inclined to assign undue importance to one factor of the equation of values or to make arbitrary adjustments to maintain the equation. It must always be borne in mind that assets and equities are coincidentally determined.⁴⁷ The value of an asset depends upon the right to use and sell which is an equity or ownership characteristic; the value of an asset also depends upon how it

⁴⁵"Transfer at a price either substantially above or below fair market value at date of transfer is usually undesirable even from the standpoint of a controlling stock interest and is indefensible from the standpoint of minority stockholders and creditors." Paton, "Cost and Value in Accounting." op. cit., p. 192.

⁴⁶"Even if a superior level of income persists beyond the period anticipated, the amortization of the cost of goodwill in terms of the original computation is generally justified on the ground that there is no way of demonstrating that the later earning power is due to factors and conditions present when the business was acquired." Paton and Littleton, op.cit., p. 93.

⁴⁷"Although the expression 'cost' is usually associated with assets, either in original status or as converted or expired, it must not be forgotten that equities or rights in assets must also be recorded, and that such recording should be consistent with the treatment of asset factors. ... In other words, the standard of recorded cost applies to both sides of the balance sheet." Ibid., p. 37.

may be used which is a physical characteristic.⁴⁸ The equation assets equal equities is really an identity with each part acting as a check upon the other parts.

The Accounting Unit

In preparing accounting statements, a segment of the total of economic values and activities is sorted out and the details are arranged in a fashion that will be useful. Ultimately the benefits to be derived from statements all flow to the residual owners but from diverse angles, such as improving management through accounting aids to management, facilitating the establishment of credit, rendering of reports to governmental agencies, supplying data for ownership investment analysis, and other matters. Whenever there is a tendency for the ownership unit to differ from the management unit, the best solution is to account for the ownership unit and to engage in departmentalization to reflect the various management units.⁴⁹

The income statement shows activities and the balance sheet shows the properties dedicated to and the interests which share in the activities. If the boundaries are described in such a way that the activities included are harmonious, both statements will be easier to interpret. For example, a man owns and manages a farm, a grocery store, and an apartment house. By reporting for the three different activities

⁴⁸ For a thorough study of the relationships of assets and equities see, W. H. Hord, "A Neglected Area of Accounting Valuation," The Accounting Review, XVII, 335, Oct., 1942.

⁴⁹ "The balance sheet ... is useful to the general management, especially the officials in charge of finances. ... In the detailed work of administration it is the highly specialized schedules, analyses, and reports, prepared to throw light on particular matters, which must be depended upon by the responsible parties." W. A. Paton, Essentials of Accounting, p. 742, N. Y., 1938.

separately, he will be much better fortified with information. Since the success of one does not depend upon the success of the others, he has the choice of disposing of each individually. But suppose he forms a corporation to own and operate the three businesses, sells shares in the corporation, and gives up his management function. As an owner with a voice in the management he will still have a say as to whether all three activities will be continued, but he, by himself, cannot dispose of the farm without disposing of the grocery store and the apartment house. If one activity proves unprofitable, the profits of the others may still make ownership of the corporate shares attractive. Attempts to report for homogeneous activities within the corporate entity, unless set forth in separate analyses, may lead to reporting for an ideal situation rather than the actual situation.⁵⁰

Faced with setting the limits of portrayal for consolidated statement purposes the accountant is likely to feel that at last he is free to choose boundaries without considering the corporate restrictions. That accountants have attempted to select the ideal boundaries in describing the area of consolidation is evidenced by such terms as the economic entity, area of integrated activities, business entity, management entity, operating entity, and others used to refer to the extent of the reports. In some cases there may be an ideal that can be satisfied, but it would seem more likely that the oneness or integration that the accountant seeks is a mirage. The total economy is an entity as is each

⁵⁰"The corporation's most important accounting responsibility, in other words, does not run to one or more owner-operators for each enterprise, but rather to one or more groups or classes of detached investors, present and prospective, for each business unit." Paton and Littleton, op. cit., p. 2.

subdivision. Any business is composed of numerous units of various sorts and is a part of numerous units of various sorts.⁵¹ The accountant is searching for harmony rather than unity.

The statements must depict the facts according to the uses to be made of the facts. Reports to owners should report the facts of the ownership, and, if the ownership encompasses a conglomeration, that fact should be shown along with any analyses that may serve to clarify the middle. Contentions that, since the stockholders do not have the necessary training to understand the statements, the accountant is free to devote his attention to reporting to management may have some validity although a more obvious conclusion would be that the facts should be reported in a more understandable form.⁵²

Stock held by a corporation for the purpose of controlling the actions of another corporation may, if the holding is sufficient, have the effect of fusing the two corporations. With the exception of Hoxsey,⁵³

⁵¹"In some instances a department or other section of the business unit may assume sufficient importance to justify treatment, for certain purposes, as a subordinate form of entity. In other instances a number of distinct corporations may be so closely related as to justify treatment of the group, for certain purposes, as one corporate enterprise." Ibid., p. 9.

See also Bonbright and Means, op. cit., p. 83.

⁵²"... it seems best to establish standards of corporate reporting upon the assumption that a fiduciary management is reporting to absentee investors who have no independent means of learning how their representatives are discharging their stewardship." Paton and Littleton, op. cit., p. 98.

⁵³"Consolidated statements would appear to be of use to management only as to the broadest aspects of the business. They must be practically useless to the short-time creditor, unless accompanied by parent company statements. Why not let them attain their maximum usefulness to the stockholder by preparing consolidated accounts including all corporations in which directly or indirectly there is a holding of a majority of the voting stock?" J. M. B. Hoxsey, "Accounting for Investors," The Journal of Accountancy, L, 259, Oct., 1930.

H. W. Bordner expresses the same idea, "Consolidated Reports," The Accounting Review, XIII, 291, Sept., 1938.

there are few proponents of letting inclusion in consolidated statements depend entirely upon majority ownership of the residual shares, although there are some who advocate measures which would produce this result in the income statement.⁵⁴ Technically, it may be insisted that ownership of a majority interest for the purpose of control includes the controlled company in the holding company system and that exclusion from the consolidated statements of such a subsidiary is literally impossible. Actually, those who talk of exclusion refer to a treatment of the investment aspects rather than the broader interrelationships of the ownership. There are probably several situations in which the investment aspects should be stressed.⁵⁵ An investment in the shares of a foreign corporation subject to exchange and other restriction may be a good example.⁵⁶ The reason for the preparation of consolidated statements is the inadequacy of the individual statements; inclusion must be complete enough to overcome this inadequacy.⁵⁷

⁵⁴Sunley and Carter, op. cit., p. 324, point out that General Motors Corporation uses this method for certain subsidiaries. But C. G. Blough objects to placing the two statements on different bases, Accounting Series Release, no. 7, p. 3, Securities and Exchange Commission.

⁵⁵Does inclusion depend upon the whim of the accountant? "A number of different points may have to be considered, aside from the size of the minority interest outstanding, before deciding that consolidation is advisable. These points include the amounts of the intercompany transactions and the outside business done, the similarity of the methods of production and distribution, the proportion of the fixed assets and current assets of each company to its total assets, the capital structure and size of the two companies, the amount of the bonded debt outstanding, and so on." P. F. Brundage, "Some Shortcomings in Consolidated Statements," The Journal of Accountancy, L, 287, Oct., 1930.

⁵⁶G. O. May, Financial Accounting, p. 33, N. Y., 1943.

⁵⁷Like individual statements, consolidated statements are subject to manipulations and inadequacies when there are excluded subsidiaries. "As a case in point a certain very large corporation formerly published consolidated statements, including only its wholly owned subsidiaries. These statements apparently justified the dividends which were regularly

Illustration of Elementary Consolidation Procedures

The following case illustrates the preparation of consolidated statements of a parent and subsidiary company at the date control was acquired and after one year of operation. Since investigation of the impact of a minority interest upon the general problems is a major purpose of this study, it will be well to defer treatment of the minority until the general nature of this type of interest can be explored.

The two illustrative balance sheets below were prepared as of December 31, 1947, just after Parent Company purchased all of the capital stock of Subsidiary Company at a cost of \$60,000.

Parent Company
Balance Sheet
December 31, 1947

<u>Assets</u>		<u>Equities</u>	
Current assets	\$ 40,000	Current liabilities	\$ 10,000
Investment in Subsidiary Company (cost)	60,000	Capital stock	150,000
Plant assets (net)	<u>90,000</u>	Earned surplus	30,000
	<u>\$190,000</u>		<u>\$190,000</u>

paid. It also held from 75% to 85% of the stock of certain large unconsolidated subsidiaries. When asked to publish either fully consolidated statements or separate statements of the subsidiaries, it developed that the company's proportion of the current losses of the unconsolidated subsidiaries had for years been larger than the total profits of the rest of the system as shown by the consolidated statements. Certainly in this case, however unintentionally, the stockholders had been misled." Hoxsey, op. cit., p. 259.

"Separate financial statements of each subsidiary presented with those of the parent comprise the jig-saw pieces of the picture puzzle. Such separate statements provide the data in accordance with legal concepts, minimize the possibilities of inadequate disclosure and avoid the dangers of misconstruction, but they leave the major work of summarization and diagnosis to the more or less helpless investor." V. F. Stempf, "Consolidated Financial Statements," The Journal of Accountancy, LXII, 358, Nov., 1936.

Subsidiary Company
Balance Sheet
December 31, 1947

<u>Assets</u>		<u>Equities</u>	
Current assets	\$ 20,000	Current liabilities	\$ 15,000
Plant assets (net)	50,000	Capital stock (stated value)	35,000
	\$ 70,000	Earned surplus	20,000
	\$ 70,000		\$ 70,000

The first step in consolidation is the substitution of the underlying assets and liabilities for the investment account. It is noted that in this case \$60,000 was paid for assets having a book value of \$70,000 but subject to prior claims of \$15,000, a net book value of \$55,000. Investigation shows that the plant assets of Subsidiary Company were undervalued on the books by \$5,000. For various reasons no attempt has been made to bring the book values into agreement with this figure. The combination of the items can be conveniently accomplished by means of a columnar work sheet:

Parent Company and Subsidiary Company
Consolidating Work Sheet
December 31, 1947

	Parent Company	Subsidiary Company	Elimina- tions	Consolidated Balance Sheet
Current assets	\$ 40,000	\$ 20,000		\$ 60,000
Investment in Subsidiary Company	60,000	-	\$ 60,000	-
Plant assets (net)	90,000	50,000	-	140,000
Plant revaluation		5,000		5,000
	\$190,000	\$ 75,000	\$ 60,000	\$205,000
Current liabilities	\$ 10,000	\$ 15,000		\$ 25,000
Capital stock - Parent	150,000			150,000
Capital stock - Subsidiary		35,000	\$ 35,000	-
Earned surplus - Parent	30,000			30,000
Earned surplus - Subsidiary		20,000	20,000	-
Surplus from plant revaluation		5,000	5,000	-
	\$190,000	\$ 75,000	\$ 60,000	\$205,000

Parent Company and Wholly Owned Subsidiary
Consolidated Balance Sheet
December 31, 1947

<u>Assets</u>		<u>Equities</u>	
Current assets	\$ 60,000	Current liabilities	\$ 25,000
Plant assets (net book value)	140,000	Capital stock	150,000
Excess security cost attributable to plant	5,000	Earned surplus of Parent Company	30,000
	<u>\$205,000</u>		<u>\$205,000</u>

After the subsidiary's book values have been brought into agreement with the acquisition price of the securities (and the whole residual ownership is possessed by the parent), elimination of one against the other leaves the items to be displayed on the consolidated balance sheet at the acquisition date.

As time passes and the subsidiary makes profits or losses and engages in transactions with the parent company new consolidation problems arise. The first two columns of the following consolidating work sheets represent the balance sheet and income statement conditions of the two companies after one year of operations. It is assumed that the extra plant value has been subject to a depreciation of \$500, assignable as an operating cost of 1948.

Parent Company and Subsidiary Company
Consolidating Work Sheet of Balance Sheet Items
December 31, 1948

	Parent Company	Subsidiary Company	Elimina- tions	Consolidated Balance Sheet
Current assets	\$ 60,000	\$ 24,000		\$ 84,000
Due from Subsidiary Company	2,000		\$ 2,000(2)	-
Investment in Subsidiary Co.	60,000		60,000(1)	-
Plant assets (net)	98,000	47,000		145,000
Plant revaluation		4,500		4,500
	<u>\$220,000</u>	<u>\$ 75,500</u>	<u>\$ 62,000</u>	<u>\$233,500</u>
Current liabilities	\$ 20,000	\$ 10,000		\$ 30,000
Due to Parent Company		2,000	\$ 2,000(2)	-
Capital stock - Parent	150,000			150,000
Capital stock - Subsidiary		35,000	35,000(1)	-
Earned surplus - Parent	50,000			50,000
Earned surplus - Subsidiary				
At acquisition (plus realiza- tion of plant appreciation)		20,500	20,500(1)	-
Since acquisition		3,500		3,500
Surplus from plant revaluation		4,500	4,500(1)	-
	<u>\$220,000</u>	<u>\$ 75,500</u>	<u>\$ 62,000</u>	<u>\$233,500</u>

(1) Elimination of the investment cost against the residual equities as of the acquisition date.

(2) Cancellation of the intercompany claim for consolidated statement purposes.

Parent Company and Wholly Owned Subsidiary
Consolidated Balance Sheet
December 31, 1948

<u>Assets</u>		<u>Equities</u>	
Current assets	\$ 84,000	Current liabilities	\$ 30,000
Plant assets (net)	145,000	Capital stock	150,000
Excess security cost attributable to plant	4,500	Earned surplus	
		Parent Company	50,000
		Subsidiary Company since acquisition	3,500
	<u>\$233,500</u>		<u>\$233,500</u>

**Parent Company and Subsidiary Company
Consolidating Work Sheet of Income Statement Items
For the Year Ended December 31, 1948**

	Parent Company	Subsidiary Company	Elimina- tions	Consolidated Income Statement
Revenues (including dividends)	\$200,000	\$ 90,000	\$ 15,000(1) 6,000(2)	\$269,000
Expenses	180,000	80,000	15,000(1)	245,000
Depreciation on revalued plant (credit carried to surplus at acquisition)		500		500
Net income to investors	\$ 20,000	\$ 9,500	\$ 6,000	\$ 23,500
Dividends declared	-	6,000	6,000(2)	-
Net additions to surplus	\$ 20,000	\$ 3,500	-	\$ 23,500
Surplus, Jan. 1, 1948	30,000	20,000	\$ 20,000	30,000
Surplus, Dec. 31, 1948	\$ 50,000	\$ 23,500	\$ 20,000	\$ 53,500

(1) Intercompany sales of goods, none of which are on hand Dec. 31, 1948, amounted to \$15,000.

(2) Dividends declared and paid by the subsidiary to the parent company amounted to \$6,000.

**Parent Company and Wholly Owned Subsidiary
Consolidated Income Statement
For the Year Ended December 31, 1948**

Revenues		\$269,000
Expenses	\$245,000	
Depreciation of excess cost of plant	500	245,500
Net income carried to surplus		\$ 23,500
Earned surplus January 1, 1948		30,000
Earned surplus December 31, 1948		\$ 53,500

Surplus per balance sheet:

Available to Parent Company stockholders without transfer	\$ 50,000
Parent Company surplus remaining in Subsidiary Company	3,500
Earned surplus (as above)	\$ 53,500

The investment cost can now be equated with the equity applying to the stock by adjusting for the unabsorbed excess of securities cost, transferring to acquisition surplus the amount of the excess realized, and segregating the surplus accumulated since acquisition. It should be noted that the profits reported by Subsidiary Company are larger by \$500 than the profits carried to the consolidated income statement. The cost of the plant for group purposes is greater than the net remaining cost on the books; the expenses will also be greater as this cost is absorbed. Claims running between the two companies must be eliminated to avoid showing a claim of the group against the group as an asset and a debt.

There are two interesting income statement eliminations. The \$15,000 intercompany sale is included in the revenues of the selling company and in the expenses of the company that bought the goods, for the goods were all resold during the year. By offsetting the intercompany sale against the expenses, the final sales price is matched with the original cost of the goods without duplication. Dividends declared by Subsidiary Company remain in the group and must be eliminated. Earnings appropriated in this manner are effectively transferred to Parent Company and are one step nearer to its stockholders.

Summary

An exhaustive study of consolidation principles and procedures should serve to integrate the various phases and clarify the results. It is felt that by devoting more attention to minority interest and valuation aspects new light may be shed on most of the troublesome problems.

Consolidated statements designed to show the financial conditions and activities of a holding company system came into popular use in the

early part of the present century before adequate attention had been devoted to the problems and principles involved. Since individual company statements are inadequate in holding company situations, and since the advantages of the holding company system have brought about widespread use of this organizational device, considerable attention to the problems of devising consolidated statements to satisfy the need for a more adequate portrayal is justified.

Two situations are important in a holding company system - the individual company position and the broader economic relationships of the affiliated companies. The affiliated companies may be treated as one compound company to reveal the broader economic aspects by assuming that purchase of a majority of the residual shares of a company for the purpose of controlling that company constitutes purchase of the business.

It is important that the data of the individual companies be accumulated according to sound and consistent accounting principles in order that the combined figures may have maximum significance. In preparing the reports to stockholders care should be taken to insure that financially important legal positions are displayed, that going-concern aspects of valuation are stressed, that there is a full and fair disclosure of factual information, that the proper relationships between assets and equities are presented, and that the boundaries of the consolidation are inclusive enough to overcome the inadequacies of individual statements.

CHAPTER II

THE NATURE OF MINORITY INTERESTS

It was pointed out that consolidated statements appear to be justified whenever a corporation holds a majority of the residual shares of another corporation for purposes of control. All rights in the subsidiary not held by the parent company must be treated in such statements as claims against the group assets. The first step in the process of setting up these interests is the determination of the amount of the claims. No great liberties are taken with the debt of the subsidiary except to apply the debt to a broader base. A minority interest in the residual shares of the controlled corporation, however, participates in gains and losses, giving the minority a continuing share in value changes and making it difficult to determine the amount of the claim at any date. It is not quite accurate to make the simplifying assumption of a merger as does Moonitz, "...consolidated statements should reflect the status and operations of the affiliated group as though it were fused in the legal as well as the economic sense."¹ Consolidated statements cannot show the joint position of the parent and its subsidiary as if the two were legally merged, because there must be an elimination of the minority to bring this about and the conditions for such an elimination are not known until negotiations between the parties have been completed. In order to arrive at a meaningful consolidated statement portrayal of a minority interest in a subsidiary company it is necessary to study the

¹M. Moonitz, The Entity Theory of Consolidated Statements, p. 13, American Accounting Association, monograph no. 4, Chicago, 1944.

financial and legal characteristics of minority interests and the relationships of such interests to other group interests.

The Position of the Minority

Any stock in a subsidiary company, preferred or common, not acquired by the parent company or another subsidiary is said to be held by the minority. For convenience the term minority will be used to refer to an outside interest in a subsidiary company although the term, in general usage, implies nothing as to the manner of the holding of the majority interest. Preferred stocks without voting power and limited as to dividends and participation in liquidation are similar to debts and can be carried to the consolidation in a fairly reasonable fashion. Participating preferred stocks and common stocks, however, require special consideration.

The accompanying statistics (Table II) serve to illustrate the importance of the minority relationship. Information as to larger percentages of minority holdings is not available. A holding of 5 percent or less is probably not important enough in its effects upon the relationships in the consolidated statements to deserve much consideration. A holding of over 5 percent may be. The prevalence of a minority interest of over 5 percent is well indicated. Of 10,539 domestic subsidiaries, 1,636, or about 16 percent, had minority interests in excess of 5 percent. About 11 percent of the foreign subsidiaries were in this position. It appears from the information given that a significant minority interest may deter the inclusion of subsidiaries in the consolidated statements. Of 1,555 subsidiaries of all active domestic classes in which a minority of over 5 percent is found, 1,084 were not consolidated, about 70 percent.

TABLE II

DISTRIBUTION OF SUBSIDIARIES REPORTED BY REGISTRANTS IN 1937 BY STATUS OF
SUBSIDIARY, DEGREE OF REMOTENESS FROM REGISTRANT, AND PERCENT OF
CONTROL BY IMMEDIATE PARENT²

Degree of Remoteness and Percent of Control by Immediate Parent	Domestic			Total Inactive	Total Domestic	Total Foreign
	Consoli- dated	Active Unconsol- idated	Total Active			
All subsidiaries						
95% and over	5,583	841	6,424	1,894	8,318	1,986
Less than 95%	471	1,084	1,555	81	1,636	284
Not designated	121	151	272	313	585	424
Total	6,175	2,076	8,251	2,288	10,539	2,694
Subsidiaries one step removed from registrant						
95% and over	4,183	344	4,527	1,413	5,940	1,144
Less than 95%	293	861	1,154	63	1,217	121
Not designated	68	128	196	202	398	354
Total	4,544	1,333	5,877	1,678	7,555	1,619
Subsidiaries two steps removed from registrant						
95% and over	997	369	1,366	348	1,714	632
Less than 95%	151	198	349	14	363	117
Not designated	52	19	71	7	78	67
Total	1,200	586	1,786	369	2,155	816
Subsidiaries three steps removed from registrant						
95% and over	249	97	346	103	449	157
Less than 95%	21	21	42	2	44	31
Not designated	1	4	5	76	81	3
Total	271	122	393	181	574	191
Subsidiaries four or more steps removed from registrant						
95% and over	154	31	185	30	215	53
Less than 95%	6	4	10	2	12	15
Not designated	0	0	0	28	28	0
Total	160	35	195	60	255	68

²Securities and Exchange Commission, Statistics of American Listed Corporations, Part I, p. 163, adapted, 1940.

Subsidiaries having minorities of less than 5 percent were unconsolidated to the extent of only 13 percent. It is possible, of course, that other deterrents may be more prevalent in the minority cases. It is curious that there seems to be a greater tendency to consolidate subsidiaries with significant minority interests when the subsidiaries are two or more steps removed from the parent company.

The Reasons for the Existence of Minority Interests

A knowledge of why the minority exists may be helpful in determining how the minority should be portrayed. The following list of reasons is not necessarily complete but probably includes all of the important considerations:

1. Some shareholders of the subsidiary may refuse to sell to the parent, at least at a price the parent is willing to pay.
2. It may sometimes be considered that the parent needs only enough shares for firm control. This condition would generally apply where there is some difficulty in the raising of the necessary additional capital by the parent or where the primary reason for the control of the subsidiary lies in the effects the subsidiary is expected to have upon the profitability of the parent's own operations.
3. The existence of a minority may serve to call attention to the separation of the corporations. Whether or not this condition is recognized in practice, there are certain real advantages involved in the assurance of the insulation of the debt of the subsidiary from the assets of the parent and in separating the assets of the subsidiary from the lien provisions of the parent company debt. Berle says of this

condition:

Grant that a real independent outside interest appears in the subsidiary corporation, and we have the existence of a party not a part to the covenants of the parent, and with full right to require that the subsidiary enterprise be independently run for his proportionate benefit. If the X corporation has ninety percent of the stock of Y corporation, the holder of the remaining ten percent can (if he be a true outsider and not in fact a dummy for the parent company) at all times, both in the counsels of the corporation, and if necessary in the courts, insist that the affairs of the subsidiary be run precisely as though it were independent.³

If the primary purpose of expansion through stock ownership rests upon the maintenance of the separate legal entities, methods giving support to such separation while still giving the broader area of ownership-control are all important.⁴

4. Shares of the subsidiary may be turned over to the management or employees as a means of stimulating zeal or rewarding effort.

5. There may be directors qualifying shares outstanding. The proportion outstanding in this case would be insignificant and the facts may indicate that the shares are really on loan by the corporation.

6. The subsidiary may have some nonvoting stock outstanding which the parent company finds to be as adequate as any it could issue itself.

There are only three of the above purposes which produce a minority interest of a significant size: the minority refused to sell out; a minority maintained as a financing device; and a minority continued to strengthen the corporate boundaries. It is clear that in each of these cases the minority must be separately displayed in the consolidated reports.

³A. A. Berle, Studies in the Law of Corporation Finance, pp. 169-71, Chicago, 1928.

⁴See W. H. Anderson, Limitations of the Corporate Entity, p. 120, St. Louis, 1931. In this section he points out that subsidiary debt may have much the same result.

Significant minority interests are more likely to be found in holding company systems formed by the purchase of the stock of existing companies than in cases in which the parent company organized new subsidiary corporations. In either case the portrayal problems are substantially the same although the determination of the amounts to be displayed may be somewhat different as will be seen in the following chapters.

Illustration of the Minority Problem

In the following case the Par Co. acquired 80 percent of the shares of Sub Co. on December 31, 1947, at a cost of \$60,000:

Par Co.
Balance Sheet
December 31, 1947

Sundry assets	\$100,000	Liabilities	\$ 20,000
Investment in Sub Co.	60,000	Capital stock	90,000
		Surplus	50,000
	<u>\$160,000</u>		<u>\$160,000</u>

Sub Co.
Balance Sheet
December 31, 1947

Sundry assets	\$ 90,000	Liabilities	\$ 15,000
		Capital stock	75,000
	<u>\$ 90,000</u>		<u>\$ 90,000</u>

The elimination of the investment in Sub Co. against the book value of Sub Co. stock (the purchase was made at book value - .8 x 75,000) will leave a minority interest of \$15,000.

Par Co. and its Subsidiary
Consolidated Balance Sheet
December 31, 1947

<u>Assets</u>		<u>Equities</u>	
Sundry assets	\$190,000	Liabilities	\$ 35,000
		Minority interest in Sub Co.	15,000
		Capital stock of Par Co.	90,000
		Surplus of Par Co.	50,000
	<u>\$190,000</u>		<u>\$190,000</u>

There are obviously several objections to the above display. The minority interest is determined by taking 20 percent of the total stock equity value. Any error of valuation will affect the size of the minority interest, and subsequent profits of Sub Co. will increase the amount of this interest. While it is probable that the share of the minority is more important than the amount, it is not possible to show this condition in the consolidated balance sheet since the minority relates to its own company only.

The Legal Status of the Minority

In order to discover the rights of the minority it is necessary to investigate the rights of any stockholder in a corporation and to find out whether any of these rights are impaired in the holding company situation. An authoritative if somewhat extended discussion of the rights of stockholders is found in *Eisner v. Macomber*:

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the

corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to dissociate himself from the company he can do so only by disposing of his stock.⁵

Unless the articles of incorporation restrict the voting rights of the class of stock held, the holder of stock has the right to vote in the election of the board of directors, to vote upon any change in the purpose or charter of the company, and to pass on any bylaws. A minority stockholder has these voting rights, but whenever the vote of a majority of the shares is sufficient to carry a motion and the majority of the shares is held by a parent company, the vote of the minority cannot be very effective.⁶ Special restrictions requiring a two-thirds, a three-fourths, or even a unanimous vote to approve any fundamental change in the purpose or character of the business have been and are prevalent in the corporation codes of the various states. These restrictions apply particularly to liquidation or merger. In situations requiring extra voting power, the vote of the minority may help to decide the outcome.

⁵Eisner v. Macomber, 252 U. S. 189 at 208 (1920)

⁶Colby v. Equitable Trust Co. of N. Y., 124 App. Div. 262, 108 N. Y. S. 978. See also H. W. Ballantine, Corporations, p. 589, Chicago, 1927.

In the ordinary course of business, however, the minority of a subsidiary can not influence the selection of the management or the determination of managerial policies. Of course, these same observations would apply to a minority interest in a single company, but in the single company there may be possibilities of dislodging some of the majority shares if the majority consists of several stockholders who habitually vote together. Again there may be possibilities that, upon the death or retirement of majority holders of shares, the stock may be more widely held and the minority may come into a position in which it holds the deciding vote. Presumably a holding company system will continue without change as long as the subsidiary is profitable or is otherwise of some advantage to the parent company.

In all other respects a minority stockholder is in the same position share for share as any other stockholder. He has the right to participate in profits and in liquidation in accordance with the number of shares and type of shares he holds. He has the right to inspect the records and to receive statements, to restrain abuses of corporate powers, to insist that the management defend the corporation against wrongdoers, and to subscribe to new issues of stock in order to maintain his relative voting rights and his relative participation in earnings.⁷

Obligations of the Majority Interest

Ordinary stockholders may conduct business with the corporation as if they had no interest in the corporation, buying from and selling

⁷See Ballantine, op. cit., p. 612, and A. S. Dewing, The Financial Policy of Corporations, p. 116, N. Y., 1941.

to the corporation and holding claims against the corporation (in addition to their stock interests) which stand in the same position as any other debt. Any liens for the protection of this type of corporate debt and any other preference such a stockholder is able to secure are not subject to the objection of the other creditors. It is a different story when a majority stockholder, such as a parent company, is in the same position.

Ballantine says of this situation:

This does not apply, however, when the preferred stockholder is also a director or other managing officer, or where he is the sole stockholder, or a majority stockholder, and takes advantage of his position to obtain the preference over other creditors.⁸

Majority stockholders are in somewhat the same position as management. Good faith and diligence are required of those placed in charge of properties belonging to others.⁹ There are several situations in which careful attention to these requirements may tend to hamper the actions of a parent company in the exercise of its control over the subsidiary.

Transactions between the parent and the subsidiary should be carried on in the best interests of the corporations and should not favor any special interest. Great care should be taken to protect the rights of minorities. Anderson states this condition very clearly:

... where a parent corporation undertakes to deal in the double capacity of vendor and vendee with respect to which third parties have an interest, and where the transaction is

⁸Ballantine, *op. cit.*, p. 737, (italics added). See also 18 Corpus Juris Secundum 1158, par. 483.

⁹Heffern CoOp. Consol. Gold Min. & Mill. Co. v. Gathier, 193 Pac. 1021 at 1022 (1920); Kavanaugh Knitting Co., 226 N. Y. 185 at 195 (1919); J. C. Bonbright and G. C. Means, The Holding Company, Appendix by M. Mound, p. 346, footnote 4, N. Y., 1932.

possible only by obtaining the consent of the representatives of those equitably interested, who is one of its own officers, something more is required of the purchaser than to obtain the property on the terms most advantageous to itself. A corporation in such a relation bears a duty to those whose securities it is taking to pay for it, and makes the purchase at the peril of being called upon to prove the good faith of the transaction and the adequacy of the consideration.¹⁰

Although this condition places an extra burden upon management to insure that all intercompany transactions are carried on fairly, operations engaged in to gain an honest profit will not be unduly affected.

There are also some obligations of a controlling interest involved in the separate management of the subsidiary. In some cases it may be possible to divert revenue from or assign an excess of operating costs to a subsidiary. The management may also cause the subsidiary to engage in unsound activities. The classic case, often referred to in recent cases, concerning the interference of the court in management at the behest of the minority is *Gamble v. Queens County Water Co.*:

To warrant the interposition of the court in favor of the minority shareholders in a corporation or joint stock association, as against the contemplated action of the majority, where such action is within the corporate powers, a case must be made out which plainly shows that such action is so far opposed to the true interests of the corporation itself as to lead to the clear inference that no one thus acting could have been influenced by any honest desire to secure such interests, but that he must have acted with an intent to subserve some outside purpose, regardless of the consequences to the company, and in a manner inconsistent with its interests. Otherwise the court might be called upon to balance probabilities of profitable results to arise from the carrying out of the one or the other of different plans proposed

¹⁰ Anderson, *op. cit.*, p. 102. In support see *Southern Pac. v. Bogert*, 39 Sup. Ct. 533 at 535 (1919). The conditions of control in the case of management stock is somewhat similar, A. A. Berle, "Non-voting Stock and 'Bankers' Control'," *Harvard Law Review*, XXXIX, 673, April, 1926.

by or on behalf of different shareholders in a corporation, and to decree the adoption of that line of policy which seemed to it to promise the best results, or at least to enjoin the carrying out of the opposite policy. This is no business for any court to follow.¹¹

Reasoning in this manner the court ordered the dissolution of the Milwaukee Lithographing Co.,¹² where it was found that a majority stockholder, having placed himself in charge of management, had grossly and obviously mismanaged the concern to the detriment of a minority interest. In a less definite ruling concerning the Calumet & Hecla Mining Co.,¹³ in which a subsidiary was compelled to give up the use of its own milling facilities to another subsidiary and use facilities some distance away, the court refused to interfere. In this last case the impression is given that the ruling of the court might have been different if action had been started before the plan had been carried out and other parties not represented in court became involved.

Any stockholder of a corporation has the same rights as any other holder of the same class of stock regardless of the number of shares he holds. There have been a few cases in which the majority felt itself to be in a position to ignore the rights of minority interests and treated the corporation as its exclusive property.¹⁴ Such cases appear to be confined to small corporations in which the stockholders are ignorant of their rights and obligations.

¹¹123 N. Y. 91, 25 N. E. 201, 9 L. R. A. 527. See also *Mound op. cit.*, p. 347, and *Bowditch v. Jackson Co.*, 82 Atl. 1014 at 1017 (1912).

¹²*Goodwin v. Milwaukee Lithographing Co.*, 177 N. W. 618 (1920).

¹³*Hymans v. Calumet & Hecla Min. Co.*, 221 Fed. 529 (1915). See also *Miner v. Belle Isle Ice Co.*, 17 L. R. A. 412 at 419 (1892).

¹⁴*Thwing v. McDonald*, 134 Minn. 148, 156 N. W. 780, 158 N. W. 820, 159 N. W. 564, (1918).

Aside from the special provisions of the various state codes, it has been considered that the majority has no right to terminate a profitable business before the time contemplated when the corporation was formed. Courts probably cannot hold that this means forever or until the business gets into difficulties.¹⁵ If the majority has satisfied the voting requirements for liquidation, it still cannot require the minority to take stock in another corporation in exchange.¹⁶ If the majority does not possess the required voting power to compel liquidation, subterfuges to bring about a forced sale demonstrate a lack of good faith.¹⁷ Even if a majority has sufficient strength to vote liquidation of a profitable business, there may still be some question as to whether the majority can vote the sale of such a concern to the parent company with the intent of eliminating the minority.

There appear to be no differences in the obligations of the majority to exercise good faith and diligence whether the shares constituting the majority are held by a parent company or a natural person.

Stockholders' Suits

Although the minority stockholders have little influence in the selection of the management or in the determination of managerial policies, the minority can have recourse to actions at law to restrain

¹⁵Ballantine, op. cit., p. 592.

¹⁶Ibid., pp. 594 and 595.

¹⁷"... a corporation cannot acquire a majority of the stock of another corporation, obtain control of its affairs, divert the income of its business, refuse business which would have enabled the defaulting company to pay its interest, and then institute an action in equity to enforce its obligations against such company, with the avowed purpose of obtaining control of its property at less than its value to the injury of the minority stockholders..." Farmers Loan & Trust Co. v. N. Y. & N. R. Co., 150 N. Y. 410 at 435 (1896).

activities inimical to its position or to ask reimbursement for damages suffered. It is alternately complained that these stockholders' derivative suits involve too many difficulties to make them an effective means of preventing the infringement of the minority rights and that unscrupulous lawyers start actions for stockholders on the slightest provocation. Some states such as New York ¹⁸ require that those starting actions must have a certain rather significant percentage of the stock or must give security for costs.

There seem to be indications that stockholders' derivative suits have a greater nuisance value than real value. Brundage points out that a stockholder can start suit for a number of different reasons:

The courts, during the last few years, have emphasized continually the rights of the minority interests. A small stockholder has frequently been able to hold up a merger or sale of the business. He can petition the courts for an explanation as to why dividends are not forthcoming, and can allege improper actions on the part of the management with very little effort or expense on his part, but possibly with very serious consequences to the company.¹⁹

It is likely that Brundage has understated the difficulties. Podell refers to such suits as, "... by far the most difficult and burdensome path in the field of corporate law..."²⁰ It is the policy of the court to use discretion in entertaining motions for injunctions and other actions in order

¹⁸"Rights of Stockholders," editorial notes, Harvard Law Review, LIX, 801, May, 1946.

¹⁹P. F. Brundage, "Some Shortcomings in Consolidated Statements," The Journal of Accountancy, L, 288, Oct., 1930.

²⁰H. D. Lasswell, A. H. Dean, and D. L. Podell, "A Non-bureaucratic Alternative to Minority Stockholders' Suits," Columbia Law Review, XLIII, 1047, Nov.-Dec., 1943. See also A. A. Berle and G. C. Means, The Modern Corporation and Private Property, p. 204, N. Y., 1932.

to confine such actions to legitimate cases.²¹ A holder of a few shares will rarely stand to lose enough to justify extended suits, and joint actions by several small holders seem to be difficult to undertake because of the reluctance of slightly interested parties to incur costs and inconvenience unless the outcome is certain. Nevertheless, the possibility that action may be taken whenever there are irregularities tends to cause management to use care that they do not provide the basis for an action.

On the other hand, the effectiveness of the holding company device is threatened by the restrictions put upon management.²² The ideal arrangement of the activities of the group of affiliated companies may require that profitable business be diverted from one subsidiary to another. Or it may be found that an outright merger would improve efficiency. In either case the minority may object. In some cases parent company managements have felt that the advantages of freedom from these restrictions and objections justified the payment of an apparently excessive price for the shares of the minority.²³

In general the threat of action by a minority seems to be more effective in preventing damage than the action is in compensating for

²¹"To give the dissenting stockholder the arbitrary right to an injunction in this class of cases often will put a deadly weapon in the hands of the blackmailer and the corporation 'striker'." *Robothan v. Prudential Ins. Co. of America*, 64 N. J. Eq. 673, 53 A. 842.

²²*Bonbright and Means, op.cit.*, p. 44.

²³*F. F. Burtchett, Corporation Finance*, p. 330, N. Y., 1934. See also *Lasswell, Dean, and Podell, op. cit.*, p. 1036.

damages suffered.²⁴

Implications of Incomplete Ownership

If the parent company does not own all of the residual stock of the consolidated group, it will be necessary to recognize two classes of stock interests.²⁵ There are two aspects to the problem of showing the relationship of the minority interest in subsidiary stock to the outstanding stock interests of the parent company: the effect upon the parent company investors of the existence of a minority interest in the activities of one or more phases of the business, and the effect upon the minority of the domination of their company by a parent company.

The principal difference between the minority-majority relationship in the single company situation and the minority-parent-company relationship is the separation of the two interests in the latter case by corporate boundaries. No attempt is made to show minority and majority interests separately in reporting for a single company since both share in the total values and activities in accordance with their proportionate holdings. In the holding company situation, however, the interests apply to different areas of values and activities. There seems to be some feeling that the parent-subsidary relationship creates possibilities

²⁴"The prayer in these suits brought by minority shareholders - sometimes called derivative suits - is usually for the restitution to the corporation by the directors of sums of money, and rarely results in any specific distribution to the minority shareholders themselves." Dewing, op. cit., p. 96.

²⁵"If the parent company owns only 95% of the subsidiary stock, there is a 5% error in the assumption of effective ownership; but this error is regarded as insignificant and is adequately indicated by the inclusion of the minority interest as a separate item in the consolidated balance sheet. But if there is a 49% minority interest, the degree of error in the assumption is so great that many accountants believe the accounts of such a subsidiary should not be included in consolidated statements." H. A. Finney, Principles of Accounting Advanced, p. 286, N. Y., 1946.

for benefiting one interest at the expense of the other not found in the simple minority-majority relationship. It is undoubtedly true that additional variations of fraudulent conversion of property are made possibly by the use of this ownership device. It may even be possible to conceal such conversion more effectively in this case.²⁶ On the other hand, there do not appear to be any legitimate means of affecting the relative shares.²⁷

Financial transactions between the parent and the subsidiary such as loans in either direction appear to be mutually beneficial to the two interests if kept on a sound commercial basis. Loans made with no reasonable expectation of repayment are either foolish, if made by the parent, or fraudulent, if made by the subsidiary. In the first case the parent might be attempting to save a bad investment but would not by making such a loan influence the shares of the two interests in its favor. In the second case, the parent company stockholders or other interests could not gain, since the loan remains a debt to the subsidiary, unless no other credit sources are open to it and there is at least a forlorn hope that additional funds will enable it to avoid outright failure.

²⁶"Business eventually is not extended, and great departments of human activity are not developed, by means which are fraudulent. The use of such means in the end is suicidal." *Robothan v. Prudential Ins. Co. of America*, 64 N. J. Eq. 673, 53 A. 842 (1903).

²⁷"Many practices and procedures which might be considered undesirable in their social effects are apparently unprofitable and unreasonable from the standpoint of sound management. It would seem, therefore, that there should be a dual incentive for holding company managements to put their houses in order; the first arising from the desire to avoid any extension of public control which might result from evil effects of mismanagement, and the second growing from the sensible attitude of those who wish to manage profitably and build well financially." M. H. Waterman, Financial Policies of Public Utility Holding Companies, p. 1, Michigan Business Studies, University of Michigan, Ann Arbor, 1932.

There can be little doubt that the minority could recover damages in this case. Specific legislation to prevent loans to a parent company, such as that found in the Public Utility Holding Company Act of 1935,²⁸ appear to be superfluous and would tend to hamper legitimate transactions between the companies.

The management of a holding company system will strive to maximize the profits of the parent company. This may be best accomplished by maximizing the profits of the individual member companies. When a substantial minority exists in a subsidiary company, diversion of revenues to the parent company or to a totally owned subsidiary or an excessive assignment of operating charges²⁹ to the subsidiary with the large minority might increase the share of the parent company in the total profits of the group. On the other hand, diversion of revenues or excessive charges would reduce the parent's profits derived from the subsidiary and reduce the value of the investment in the subsidiary. Manipulations of this sort would need to be large in order to make a material difference and large manipulations could not escape the attention of the minority and the court. The minority would be able to point out a lack of good faith and the creditors of the subsidiary may be able to extend their claims to the assets of the parent.³⁰ That such manipulations are inadvisable should be obvious to any intelligent management.

²⁸Sec. 12.

²⁹See Public Utility Holding Company Act of 1935, Sec.13, for the specific limitation in this field.

³⁰In commenting on *Male v. Atchison, Topeka & Santa Fe Railway Co.*, 230 N. Y. 158, 129 N. E. 458 (1920), M. Mound, *op. cit.*, p. 377, states: "Where no funds or income of the subsidiary have been diverted by the parent, neither the original parent nor its reorganized successor has been held liable to unpaid bondholders of the subsidiary, even though the subsidiary was run as a feeder for the benefit of the parent."

A minority interest in a subsidiary company will be primarily concerned with the statements of the company to which its interest relates,³¹ since it can reasonably be assumed that the management of the parent is honest enough to avoid infringement upon the rights of the minority. Any benefits or disadvantages of the combined operations should be readily apparent in the individual company statements. On the other hand, reference to the parent company reports and to consolidated statements of the group may enable the minority to gain a better insight into the long-run managerial policies and to see its own relationship to the group of which it is a part. If there have been economies or increases in revenue accruing to the subsidiary through concerted group activities, it may be useful for the minority to investigate its own share of the growth and to forecast its future position in the group. Failure of a parent company may not cause failure of an independently operated subsidiary but there may be certain repercussions, at least upon the market value of the shares. Failures within the group which affect sources of supply or markets may change the position of a subsidiary materially. The minority must rely upon the individual company statements but it may be well to keep in touch with the progress of other member companies.

Investors in the parent company require a joint portrayal of the underlying values and activities. When such statements show the parent

³¹ Moonitz, op. cit., p. 14; E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 63, March, 1938; W. A. Paton, Accountants' Handbook, p. 1068, N. Y., 1943; and W. A. Paton, Advanced Accounting, p. 751, N. Y., 1941.

company stockholders to be in an ambiguous partnership with stockholders in subsidiary companies, the relationships between the two interests should be displayed. The minority has contributed capital to the joint enterprise and in return expects limited participation in the benefits. In some cases a minority may take advantage of every legal loophole to keep the organization and its management in a continuous turmoil of litigation and objections even though the parent company management extends itself to be fair and liberal. Of course, similar obstreperous minority interests in single companies are probably as numerous and as annoying.

For the parent company interests as well as the minority interests to appraise correctly their relative positions, the two should be reported on a harmonious basis in the consolidated statements. There seems to be some difference of opinion as to whether the proportionality of the relationship or the amounts of the claims should be stressed.³² In general, proportionality depends upon the relative amounts and the two come to the same thing - a consideration of the legal claims of the two parties. Since the minority pertains to a part while the parent company interests pertain to the whole and the amounts assigned to the two interests are accumulated under different circumstances,³³ comparison

³²"In the determination of the apportionment of consolidated net income and capital, however, as opposed to the calculation of their total amounts, the relative importance of the minority may not be ignored." Moonitz, op. cit., p. 85.

"As a result no particular significance may be attached to the ration of minority to controlling equity, but only to the absolute amounts involved." Moonitz, op. cit., p. 89.

³³Ibid. p. 80, 85, 88.

of the two becomes difficult on any other basis than the relating of the total of each interest to the total of all interests in the joint enterprise.

Alternative Concepts of the Minority

There are three principal variations in the manner of portraying the minority interest in the consolidated statements. It has been suggested that the minority is a factor foreign to the consolidation and should be excluded from the picture. Several writers insist that the minority interest is similar to a debt and should be displayed in the liability section. Finally, there seems to be some support for the treatment of the minority interest as a proprietary interest.

The minority may be excluded from the consolidation by subtracting its interest from the assets carried over from the subsidiary. Two errors are possible when this method is used. The determination of the particular asset to be reduced and the determination of the amount to be assigned to the minority may both be faulty. To avoid combining these errors the minority could be shown as a contra account to the total of the consolidated assets.³⁴ This in turn is subject to errors in that the minority has little claim against the assets of the other affiliates included in the total, and in any case the subtracting of the minority from the assets shows the minority as having a claim superior

³⁴An unusual presentation of the minority interests in subsidiaries was included in the 1934 and 1935 balance sheets of the Tennessee Corporation when the amount was shown as a contra account to the total of the assets. The Commission did not require a change in these balance sheets but only because the amount was insignificant." W. K. Pierpont, Accounting for Investors by the Securities and Exchange Commission, p. 291, an unpublished doctoral dissertation, University of Michigan, April, 1942.

to the debts of the subsidiary. To overcome these objections the minority percentage might be subtracted from each asset and liability.³⁵ By doing this the omission of the minority from the stock equity will be offset by asset and debt omissions. Consolidated statements that carry fractions of assets and debts would certainly be peculiar. Moreover, obligations cannot be assigned between parties without the consent of the creditors. Exclusion appears to be inadequate to depict the position of the minority or the position of the group.

Insistence upon the economic ownership of the subsidiary's assets by the parent leads some accountants to suggest that since the minority is not an owner then it must be a creditor. However, there is no promise to pay the minority and the amount of the claim cannot be accurately determined. If it is an outside interest but not a real debt, it may be possible to show it as a quasi-creditor, a sort of a debt, having some of the features of a debt but not enough for an unqualified classification.³⁶ Those who advocate this treatment would report the minority between the liability section and the stock equity section of consolidated balance sheets.³⁷ The discussion of the legal rights of the minority interest seems to show that the minority has few of the characteristics of debt and most of the characteristics of a stock equity.

³⁵"It is now generally considered that this method does not convey a true statement of the position..." C. J. G. Palmour, "Auditing of Concerns," Accountant, XCIC, 496, Oct. 8, 1938. "The artificiality of the resultant picture made that procedure unacceptable..." E. A. Kracke, "Consolidated Financial Statements," The Journal of Accountancy, LXVI, 377, Dec., 1938.

³⁶Moonitz, op. cit., p. 88, opposes the creditor viewpoint. W. T. Sunley and W. J. Carter, Corporation Accounting, p. 361, N. Y., 1944, point out some similar characteristics, but the similarities are those common to all equities.

³⁷Kohler, op. cit., p. 68; and Kracke, op. cit., p. 377.

The fact that the minority interest is only a partial interest in one phase of the total is cited by some writers in support of the representation of the minority as a quasi-proprietorship element. This approach, like the quasi-creditor approach, would place the minority between the debt and the stock equity. Thus the presentation between the debt and the stock equity has a double chance of being right. The use of this position, however, may indicate a failure to classify the element rather than a classification of the element.

Proceeding on the thesis that the minority has committed capital to the joint undertaking without a claim for a return of this capital and that the minority has a claim against the earnings and must share losses before the creditors suffer, one may reach the conclusion that the interest has enough of the characteristics of proprietorship to be classified in the stock equity section. There are two possibilities for such a portrayal. The minority may be shown as a division of proprietorship, and all phases of the minority equity may be segregated; or the minority could be shown as a part of generalized proprietorship, with no attempt being made to segregate the minority interest in retained earnings. Little can be said for the generalized treatment in view of the limits of the claim and other peculiar features.

Certain other conditions should also be considered. It was pointed out earlier that a significant minority interest exists only in cases in which there is some reason for a minority. If the reason is that holders of stock have refused to sell out, it is not likely that they would be content with the limited rights and participation in earnings they could so easily obtain from the parent with greater security

of principal and income by accepting a note or mortgage. If the minority exists at the choice of the parent as a means of financing the activities or adding support to the separation of the corporations, the interest is clearly a joint proprietor in the enterprise. It must be admitted that the minority may disregard the consolidated statements, but this attitude cannot serve as an excuse for treating the minority as a plug to make the statements balance or otherwise misrepresenting the relationships. The parent company equityholders must consider the amounts and relationships of all significant interests in the group.³⁸ The minority has provided capital and shares in gains and losses and it brings with it certain restrictions in the freedom of operations which must be given recognition.

It is further pointed out that the interests of the minority are not strictly parallel with the interests of the parent company investors, or in other words that the minority is not a partner³⁹ in the joint undertakings. The minority has an adverse interest to that of the parent in all intercompany transactions and is not especially concerned as to whether the group prospers. On the other hand, this is not a peculiar position even though it exist nowhere else in exactly the same form. All equities have a community of interest in the size of the total profits; all equities have adverse interests in the distribution of the profits. There appears to be little real difference in the case of the minority.

³⁸ For all comments on an all business portrayal see, Finney, op. cit., p. 262.

³⁹ Moonitz, op. cit., p. 18.

Nor can the fact that the vote of the minority does not materially influence decisions be considered as supporting the thesis that the minority is not a stock interest. Minority interests in single corporations as well as preferred stocks have no voice in the management but are universally considered a part of proprietorship.⁴⁰

The representation of the minority in the income statement should be consistent with the method employed to show the minority in the balance sheet.⁴¹ If the minority is excluded, consistency would dictate the exclusion of that portion of all the activity accounts attributable to the minority investment. If the minority is treated as a debt, the minority interest in the earnings will be reported as interest charges and in the balance sheet as interest accrued payable. If minority rights are of a proprietary character, the rights in earnings will be reported as part of the net after interest charges and in balance sheet as surplus.⁴² The minority is unquestionably in a better position with respect to the earnings of the subsidiary than is the debt of the parent company, for it participates directly in the dividends of the subsidiary while the debt of the parent must rely on the amount left after operating charges of the parent are covered.⁴³ But the minority

⁴⁰It is difficult to understand why so much emphasis is placed upon control - only one ownership characteristic - in constructing the stock equity section. The fact that the results of profitable activities must be shared should receive some consideration.

⁴¹E. J. B. Lewis, Consolidated Statements, p. 89, N. Y., 1942.

⁴²"Minority interests in the net worth of subsidiaries consolidated, unless nominal in amount, shall be shown in each consolidated balance sheet. In such case a separation shall be made between the minority interest in the capital and in the surplus." Securities and Exchange Commission, Regulation S-X, Rule 4-07, Washington, D. C., 1940.

⁴³For an interesting appraisal of the effect of subsidiary dividends upon the parent company funded debt see, G. Graham and D. L. Dodd; Security Analysis, p. 179, N. Y., 1940.

is certainly in an inferior position with respect to the debt of the subsidiary and is in no position at all with respect to the independent earnings of the parent and other subsidiaries. There is a question as to whether the one case of a superiority over the parent company debt places the minority in a creditors position of the parent debt in a stock position.

The question remains as to whether the minority interest should be reported just above the stock equity title or just below the title. This is not a question of academic interest alone, for it has implications with respect to the determination of the excess of the cost over the book value of the stock acquired and with respect to the treatment of the minority interest in intercompany charges. Although particular situations may lead to different conclusions, it will be well to think of the minority as a stock equity, which it is literally, and more particularly as an associated proprietary interest.

Summary

An outside interest in the shares of a subsidiary gives rise to some statement portrayal problems not found in accounting for a single corporate enterprise. Significant minority interests of this type appear in enough instances to justify an extended investigation of the nature of the interest and the best means of showing its effects in the consolidated statements. Important minority interests arise when holders of the shares of a company refuse to sell to the parent company at a price the parent is willing to pay, when the parent makes use of the minority to help finance the expansion, and when it is desired to strengthen the legal boundaries between the parent and the subsidiary.

A minority interest in a subsidiary has all of the rights of any shareholder in the subsidiary company, but, being a minority, its vote in stockholders meetings cannot have much influence in the election of directors or in shaping general policies. When the majority of the shares of a company are held by one person, as they are in the holding company situation, the holder of the control must act in a manner calculated to protect the other interests rather than in his own interest exclusively. If the minority feels that its investment has suffered or if likely to suffer, it can petition the court to award damages or to restrain the management. The threat that such action may be taken is probably more effective in preventing infringement of minority rights than the actions are in reimbursing the stockholders for damages suffered.

The consolidated statements must show the relationships between the minority and the parent company interests. The minority will be concerned with such statements in only a general way since it is reasonable to assume that the management of the holding company is honest enough and intelligent enough to avoid infringing upon the rights of the minority. The parent company investors, however, will be interested in the size and the nature of the minority.

Of the three possible ways of preparing consolidated statements involving minority interests - exclusion of the minority, treatment of the minority as a debt, and reporting the minority as an associated proprietor - the proprietary representation seems to correspond more closely to the nature of the rights. The minority has irrevocably committed its capital to the business and shares in the profits and losses.

CHAPTER III
SECURITY COST AND BOOK VALUE DIFFERENCES
AT ACQUISITION

The subsidiary relationship may be formed in two different ways, each producing its own special problems. If a company segregates property, forms a new corporation to hold the property, and takes shares of stock in the new corporation in exchange for the property, it is unlikely that there will be any difference as the acquisition date between the book value of the property as carried by the subsidiary and the investment in securities of the subsidiary as carried by the parent, and it is unlikely that there will be any significant minority interest in the subsidiary. If, on the other hand, a company purchases securities of an existing company, it is probable that the cost of the securities will differ somewhat from the book values of the subsidiary company (e.g. illustration of Chapter I), and it may be that the parent company will be unable or unwilling to purchase all of the capital stock of the subsidiary. It is possible that significant minority interests may exist in cases which involve no problems of reconciling divergent costs, but it is more likely that the problems of reporting for a minority will be accompanied by problems of assigning cost differences.

The Components of the Difference

For consolidated statement purposes the cost of the securities represents the cost of the underlying assets (subject to the other obligations of the subsidiary) to the parent company, while book value presumably represents cost to the subsidiary. To combine the parent and

subsidiary assets on one statement, the accountant must be able to explain the reasons for the differences in value and must restate these differences to reflect the position of the ownership-control element in harmony with the associated interests of the subsidiary. The first requirement for this portrayal is a thorough understanding of the reasons for the existence of a difference between the cost of the subsidiary's capital stock to the parent and the book values of the subsidiary's assets and debt.

It may be that the book values of the subsidiary are in error, not correctly representing all of the assets of the company or all of the obligations. Even if all of the items are included, accounting for a going-concern emphasizes cost as the basis of valuation, and cost of many items will vary from current values. To determine the difference attributable to errors, it will be necessary to inventory all resources, to accrue all increases and growths, and to examine all value assignments. Differences which are due to changes in value can only be determined by appraisal.¹

Either the purchaser or the seller of the securities may have incorrectly appraised the real value of the subsidiary. It is always necessary in the case of the purchase of special properties to examine

¹"Unsatisfactory depreciation policies, obsolescence of certain installations not acknowledged in the accounts, and an inadequate treatment of deferred charges and credits are some of the reasons why book balances may be unreliable as a measure of fair market value. Moreover, even if no errors or inadequacies of the types just listed are assumed, it must be recognized that conventional accounting procedures are not geared to reflect exchange values. As a consequence it would be surprising indeed to find a case in which a company acquired an interest in a going concern at a fair price which exactly equated with book value." M. Moonitz, The Entity Theory of Consolidated Statements, p. 63, American Accounting Association, monograph no. 4, Chicago, 1944.

the possibility that the cost of an item may not represent the current value of the item. On the other hand, the real value of a conglomeration of assets and debts is indeterminate within wide ranges of value. Although a profit or a loss on security purchases probably exists in most cases, it is impossible to take this factor into account in reconciling cost with book value except in the most obvious cases. In a sense, value is determined in exchange, and unless there is an indication that property acquired could be immediately resold at a higher price or that the property has less value in use than its cost or has a lower resale value, it must be presumed that the cost of the item reveals its value.

Another disturbing factor is the value of a consideration other than cash given in exchange for the securities. The cost of the property acquired should be determined by the value of the items given in exchange. Incorrect appraisal of the value of the consideration on the part of either the buyer or the seller introduces a gain or loss which may either augment or offset a gain or loss involved in incorrectly valuing the securities purchased. Exchange of properties for stock is probably rare but there is a similar situation that is very common. Outstanding stock of a subsidiary is often exchanged for stock of the parent company. Acquisition of stock directly from a company is never an exchange of property for property; it is a contribution of an owner to an enterprise, a capital commitment. In this case, accordingly, there is no capital commitment of the parent in the subsidiary. The owners of the subsidiary have merely associated themselves with the owners of a larger area, contributing their ownership of the subsidiary for ownership in the joint endeavors. The circumstances may indicate that in this exchange the

parent company stock was issued at a premium or a discount. The quoted value of the parent company stock will offer a clue as to the issue price of the parent company stock and the value of the stock acquired.² Chapter VIII will consider the case of a direct exchange of stock with the subsidiary company.

The value of a going business is not determined by the value of the properties alone. In the final analysis a business is desirable only if it is profitable. The earning position of a company may justify a larger payment for its stock than the value of its physical properties would seem to indicate. This again points up the fact that book values may not represent current values of a concern. On the other side of the picture, there may be an obstruction to the free disposal of properties which will make the stock of a company in a poor earnings position less valuable than the sum of the values of the underlying assets.

Regardless of the difficulties, there is no excuse for an oversimplification of the portrayal of the difference between the cost of the securities and the book values. Any tendency to assert that, since the difference is usually attributable to "goodwill", the difference can be shown as "goodwill" in all cases is inaccurate to say the least,³

²"If the consideration given for any investment is other than cash or securities issued by the acquiring company, the cost of the investment acquired shall ... be deemed to be the fair current value of the consideration given. If the consideration given for any investment consists of securities issued by the acquiring company, the cost of the investment acquired shall be deemed to be the fair current value of such investment." Securities and Exchange Commission, Accounting Series Release No. 39, p. 3.

³"In most discussions of the technique of consolidated reporting, and to some extent in practice, the error is made of assuming that the amount by which the investment account of the holding company exceeds the book value of the stock, in the subsidiary's accounts, invariably repre-

and when this tendency is further elaborated to the point that the amount of the reconciliation is continued indefinitely without change, the result is a failure to account for this element. Errors in book values should be corrected immediately on the subsidiary's books. Furthermore, it is not difficult to find justification in accounting theory for the adjusting of the book values where the difference is due to a change in the value of the subsidiary's properties.⁴ At the acquisition of control and the institution of a new management the subsidiary is essentially a new organization and a quasi-reorganization would clearly be suitable.⁵ An adjustment of the books of the subsidiary to reflect the purchase price of the securities has the advantage that all subsequent combined portrayals will be facilitated and will more clearly display the relationship of the subsidiary to the parent. However, a substantial minority interest in a subsidiary may

sents goodwill - a premium paid for superior earning power. In one case where the subsidiary company owned a large tract of cypress the reconciling balance was reported as goodwill although the circumstances indicated clearly that in the increase in the quantity and value of the cypress over a period of years was the explanation of such balance." W. A. Paton, Advanced Accounting, p. 759, N. Y., 1941.

⁴H. R. Hatfield investigated the general case for the recognition of appreciation very thoroughly in his lectures at Harvard, Surplus and Dividends, Harvard University, 1943.

⁵"To overlook the matter of the appreciation of a subsidiary's assets as of date of acquisition is incorrect as it inflates the goodwill. The individual balance sheets of the constituent companies should give correct values even if an appraisal is necessary to secure these values. Of course, all unrealized increases in value must be credited to a Reserve for Appreciation account instead of the ordinary Surplus account." G. H. Newlove, Consolidated Balance Sheets, p. 250, N. Y., 1926.

"With this condition it may be argued that although continuous revision of accounts to conform to estimated market values is uncalled for and undesirable, an adjustment as a result of a transaction which is closely allied to the outright sale of the enterprise is entirely proper." W. A. Paton, op. cit., p. 756.

make the direct adjustment of the subsidiary's books less advisable.⁶ From the standpoint of the minority the development of their company will be clouded by any such material changes in the accounts, and the minority will not have as good a basis for comparing the success of the company before and after the acquisition by the parent. Whether the books are adjusted or not it will still be possible to reflect the components of the difference in the consolidated statements in the proper fashion.⁷

It is not clear that there is much to be gained by taking up the cost of excess (or deficient) earning power on the books of the subsidiary. Accounting in subsequent periods will not be greatly facilitated by this adjustment and the item is not necessarily related to the subsidiary exclusively. A thorough attempt should be made, however, to determine the nature of the excess earning power for correct delineation on the consolidated reports.

On the purchaser's side of the picture, no haphazard recording of the cost of the securities can be condoned. If the parent company issued its own stock at a discount in exchange for the securities of the

⁶"...since the acquisition of the subsidiary stock may be regarded, from the consolidated standpoint, as an acquisition of subsidiary net assets, it may be proper to give recognition to increased market values in the consolidated balance sheet, although such recognition might not be permissible in the balance sheet of the subsidiary." H. A. Finney, Principles of Accounting Advanced, p. 289, N. Y., 1946.

⁷"...it was argued that becoming a subsidiary was a major event in the life of a corporation and that an appraisal of the subsidiary should be made as of date of stock control. Such a procedure greatly lessens the difficulty of preparing consolidated statements and has the added advantage of stating the minority interests on the same valuation basis as the majority interests." G. H. Newlove, from manuscript titled, "Consolidate Statements," ch. 4.

subsidiary, some method of displaying the discount effect should be used rather than resorting to an inflation of the value representation of the securities.⁸ Adjustment of the security cost to reflect highly conjectural gains or losses on the purchase of the securities can also be dispensed with conveniently.

The Earning Power Component

Excess (or deficient) earning power is an ever-present component of the difference between cost of securities and book value. A simple determination of the nature of this item is usually impossible for it arises whenever enterprise earnings are more than enough to compensate for the employment of the inventoriable assets (or whenever this earning power is not a sufficient reward for such employment). The following listings of the various factors tending to produce an earning power valuation different from the sum of the values of the tangible assets is extended but not necessarily complete.

Certain factors tend to produce in the subsidiary a value in excess of the value of inventoriable assets:⁹ (1) going-concern value or cost of getting an organization started; (2) favorable attitudes of the buying public, of employees, and of others; (3) favorable location such

⁸"In view of the present trend in corporation laws away from discount liability there is no important barrier to its explicit recognition in the accounts of the parent company." W. A. Paton, Accountants' Handbook, p. 1078, 3rd ed., N. Y., 1943.

On the other hand, "Thirty-two states deny the right of corporations to issue either preferred or common stock at a discount..." L. J. Benninger, "State Law in Regard to Paid-in Surplus," The Accounting Review, XXI, 59, Jan., 1946. He lists among such states: Delaware, New Jersey, New York, and most of the other important states.

⁹F. H. Streightoff includes a thorough analysis of such conditions in a somewhat different form. Advanced Accounting, p. 425, N. Y., 1932.

as nearness to market, to good labor supply, to raw materials, and to other items; (4) ability and training of management and employees; (5) sound credit position producing "cheap" sources of temporary capital; (6) advantages of an early start which have put the company a step ahead of competitors; and (7) monopolistic factors such as favorable rate rulings, value of patents and processes, value of franchises, restrictions on entry of competitors arising from capital characteristics, and others.

Certain advantages not present in the acquired company may be realized by affiliated companies:¹⁰ (1) pooling technical experience; (2) elimination of ruinous competition not only in pricing but also in bidding for the factors of production; (3) vertical control of prices; (4) control of raw materials and other resources; (5) outlet for unused capacity such as plant, management, marketing channels, and others; (6) improvement of service to customers; (7) elimination of selling costs; and (8) tapping new markets.

Certain factors tend to decrease the value of the concern below

¹⁰See S. Walton and C. H. Langer, Advanced Accounting, L 31-2, Chicago, 1934.

"We are not to conclude that the chain has no value because it has no earnings, nor are we to conclude that it has a mere scrap value represented by the liquidation of its property. A chain store management from some other city could acquire the profitless chain of stores and, applying improved administrative skill, transform a loss into a profit... Consequently, one of several possible buyers will pay some price for the profitless chain in the expectation that an improved management will be able to produce earnings. The business has an established position, a potential earning capacity, which some one will value in terms of earnings yet to be realized." A. S. Dewing, Financial Policy of Corporations, p. 314, N. Y., 1941.

the value of the inventoriable assets:¹¹ (1) cost of liquidation of the assets exceeding the difference in value of the items from their composite value; and (2) temporary business conditions have unduly depressed the value of the stock.

The seven factors explaining an excess value existing in the subsidiary company as a separate enterprise may be classified into two main types - those having determinable lives, and those having indefinite existence. All of them however, require continuous attention and most of them will eventually vanish without renewal efforts. The following eight factors exist in the combination of companies, producing increased earnings primarily in the groups of companies. It is noteworthy that the latter factors appear to have longer lives. The last set of conditions producing excess value of the assets tend to be of short duration.

Assignment of the Difference

It is well recognized in accounting that the value of the whole may not be the sum of the value of the physical parts. Accountants have long since given up the attempt, if indeed they ever tried, to reflect current economic values in the records or statements and have been content to have the statements reflect economic efforts and trends. The impossibility of accurately determining the value of the parts or even of major phases is indicated by Dewing:

A corporation operating a normal business will be found to possess three distinguishable parts, each making its necessary contribution to the integrated whole - the normal going business. They may be called the permanent property or capital of the

¹¹"The advantageous purchase may be due to one or a combination of economic factors, such as current trade conditions, financial embarrassment by reason of undercapitalization, or competition by large scale producers, etc." Walton and Langer, op. cit., L. 32-5.

business, the current capital and finally the group of intangible values which distinguish the going business from the dead business, and which we call the organization. The separate values of these three parts cannot be determined; the business is the joint product of the three, and the value of the business is the value of the three united in the form of a single operating unity.¹²

More accurately, value can be assigned to the parts, cost value or exchange value, but the value of the parts in their particular use can only be said to be more or less than the ascertainable values of such parts. For this reason intangibles of the nature of goodwill are thought of as adjuncts to the sum of all assigned values.

The General System

A lump-sum reporting of the value of securities of an affiliated company will suffice to report the investment aspects on the parent company's books. Reporting for the subsidiary as a part of the joint business,¹³ however, requires the assignment of the total value of the subsidiary to its component parts for purposes of showing values available for future activities as well as values contributing to current revenues.¹⁴ If the purchase was based upon an appraisal of the

¹²Dewing, op. cit., p. 291

¹³"It seems that the circumstances of the acquisition of subsidiaries by the parent should control the basis of stating the amounts of assets of each subsidiary included in the consolidation, as opposed to the theory that the consolidation should reflect a summarization of the cost of assets to the respective constituent companies. The latter hypothesis does not appear to be consistent with the single-company theory, because it injects the legal concept of separate corporate entities. It would follow that cost to the subsidiary is cost to the consolidated group only if the expenditure occurred subsequent to the acquisition of the subsidiary by the parent." V. F. Stemph, "Consolidated Financial Statements," The Journal of Accountancy, LXII, 365, Nov., 1936.

¹⁴"The elimination of intercompany common or equity stock holdings proceeds on the theory that the acquisition of such stock of one company by another represents in effect the purchase of the former's assets, subject to its liabilities and preferred stock (if any)," W. A. Staub, "Consolidated Financial Statement," Accountant, LXXXI, 737, Dec. 7, 1929.

inventoriable assets and excess earning power, appraisal data can serve to provide the original breakdown of the cost. There tend to be several inaccuracies in these appraisal figures, for the cost may have been a negotiated amount either above or below the estimate, and quite a different set of appraisal figures may have been used by the seller in the negotiations.¹⁵ A systematic approach to value determination is a requisite for assignments of this type.

Appraisal of the Subsidiary

The first step in the allocation could well be a listing of the inventoriable assets and of the liabilities. Valuation studies of items can then be made by groups.¹⁶ In the current asset group there will be little difficulty in valuing cash or marketable securities other than an audit of the amounts and in the case of the latter a determination of the market price at the effective date of the transaction. The receivables phase of the current asset valuation will include verification of amounts and a study of collection expectations. Estimating the collectible amount of the receivables will involve accruing interest to the date of the transaction, deducting available discounts, and perhaps deducting imputed interest. Inventory valuation

¹⁵Not always, unfortunately, are the data available which will permit a precise description of the difference between the related values of the intercompany stock. The price of the stock may have been determined by reference to market quotations and without a full investigation and appraisal (a deplorable condition). And even if a complete valuation has been made it may not be feasible to apply particular items of the appraisal to an explanation of the aforesaid difference, especially in view of the fact that the actual price finally agreed upon is not likely to coincide exactly with estimated values." W. A. Paton, Advanced Accounting, op. cit., p. 759.

¹⁶Walton and Langer, op. cit., L 31-2.

is a little more difficult. Recent invoices or quotations net of discounts should be applied to the verified inventory of merchandise and materials. Adjustments will need to be made for various types of deterioration and for normal storage and handling costs. Careful examination of costing methods may sometimes be necessary in a manufacturing situation to put the inventory values on a cost-to-produce-at-the-transaction-date basis and to eliminate abnormal cost assignments. If the finished goods have a ready market, it may be correct to impute earnings to these goods and to some extent the work in process as well. Prepaid items, in the absence of rate changes, merely require proration to the effective date.

Investments in long-term securities should generally be determinable on a quoted market price basis. Care must be taken to segregate interest and dividend aspects. Items with no ready market may be valued on a yield basis. Investments in rental properties or in abandoned properties awaiting disposal and others will require special valuation. Investments in other subsidiaries or in the parent company will be considered in Chapter VIII.

Certain aspects of plant valuation will require a knowledge of local market prices for real estate. Land will be allotted a current resale value, cleared but otherwise as improved. Plant buildings and equipment can be valued on a sale basis as a starting point but replacement cost depreciated to date and adjusted for the obsolescence of the existing items may well be the ultimate goal. It may be presumed that, unless immediate replacement of the plant items is contemplated, there is some value in these items. Comparisons of the operating cost of the

plant relative to the operating costs of similar but modern properties will help to determine the reasonableness of appraisal figures.

Properties having accretion or depletion characteristics will require surveys of growth or exhaustion as well as studies of extraction costs and market trends. In this case as in the others the estimates used as the basis for the bid by the purchaser will be helpful.

The verified list of the liabilities will be examined to ascertain that the items are valued at the amount of the original contribution plus any accruals of interest or purchase discounts. If it is found that the subsidiary is paying an abnormally high rate for borrowed funds and it is anticipated that the parent will use its own credit position to refund the debt, it may be necessary to place the items on a call price basis. Any extra amount paid for the subsidiary because of a superior credit position involving lower than normal interest costs will be reflected as a part of the excess earning power rather than as an increase in the discount applicable to the debt. In general, however, the net representation of the debt should correspond to the current market quotations rather than to the book values adjusted for discount and premium (see Chapter V). It may also be desirable to deduct implicit interest from the current debt.

The Use of Appraisal Data

The total of the asset valuations above will represent the total value of the ownership of the inventoriable assets. If this total is sufficient to cover the liabilities as determined above, the difference as well as the value attributable to excess earning power apply to the stock equity. Assuming that there is only one class of

stock outstanding (the case of several classes will be considered in Chapter V), the calculation of the total attributable to excess earning power is not difficult. The parent company's proportion of the stock applied to the difference between the total value of the inventoriable assets and the debt will give the parent company's purchase of tangibles. By subtracting the total tangible value from the total purchase price, the intangible cost, or the cost of the excess earning power, is ascertainable.

Crocheron suggests a rather doubtful refinement:

This practice is somewhat arbitrary and may not hold for tax purposes in establishing a proper basis for depreciation. The proper and acceptable procedure is to have an appraisal made of all of the assets acquired - intangibles as well as tangibles - as a basis for allocating the purchase price as between tangibles and intangibles, and with a further breakdown of the tangibles according to the respective depreciable and nondepreciable items.¹⁷

This suggestion would involve appraising the various excess earning power factors as well as the tangible assets and determining the total of all assets, subtracting the liabilities, and comparing the amount of the difference attributable to the parent company with the purchase price of the securities. The excess of the purchase price over the appraised value (or the deficiency) would then be imputed from the parent company's share and prorated back to the individual appraised values. The proration would be very complex, for some of the values such as cash would not be subject to correction. This procedure is based upon the assumption that all appraisal errors are in the same direction and in the same proportion - not an unwarranted assumption

¹⁷C. Crocheron, "The Relationship of the Accountant and the Appraiser," The Journal of Accountancy, LXXXI, 29, Jan., 1946.

in cases where the purchase consists of similar items. It is difficult, however, to imagine any valuation procedures more dissimilar than those used for plant and excess earning power. It is entirely possible that an overvaluation of plant may be accompanied by an undervaluation of excess earning power or the reverse, and it is highly unlikely that errors in the same direction will be in the same proportion.

The general system of value assignment outlined relies upon careful verification of the appraisal of each item by the accountant. No pseudo-conservative values can be tolerated, for an understatement of one item will automatically mean an overstatement of the value of excess earning power. With the total value of all excess earning power attributable to the parent company's investment determined within limits of the accuracy of all the estimates but with enough accuracy to be significant, there still remains the task of the allocation of this total to the earning power components. It will generally be sufficient to limit the breakdown to items having ascertainable lives and items having indefinite lives.¹⁸ The former will consist of patents, processes, and other franchises which are not renewable and may be sometimes valued on a separate disposal basis. Royalty possibilities and cost savings will be an aid in capitalizing the value of these items. The final

¹⁸"If practicable there should be an allocation of such excess as between tangible and intangible property and any amount allocated to intangibles should be further allocated to determine a separate cost for each type (a) intangibles ("Those having a term of existence limited by law, regulation, or agreement, or by their nature...") and for at least the aggregate of all type (b) intangibles ("Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life...")." American Institute of Accountants, Accounting Research Bulletin No. 24, p. 196.

residue of the difference between the securities cost and the value of the inventoriable assets must be attributable to general "goodwill" arising from favorable conditions or situations. A careful analysis of the reasons for this last value will also be helpful in setting the value as well as providing a basis for later assignments to operations. It is only after the entire procedure outlined has been undertaken and carefully checked that any suppositions as to gain or loss on purchase can be entertained and even in rather apparent cases it will be better to understate "goodwill" than record a profit,¹⁹ but it probably is not advisable to understate "goodwill" and record a loss. Indications of profits or losses should be carefully noted, however, to insure full disclosure.

Illustration of the Use of Appraisal Data

Although the ideas involved in revising the values of the assets and obligations of a subsidiary at the date of acquisition of control are fairly simple, the manipulations required to take the

¹⁹"Consolidation surplus bears all the earmarks of paid-in surplus and could be called by that name if the subsidiary that gave rise to it were dissolved and the net assets were taken over by the parent." E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 69, March, 1938.

"Because of the practical difficulty of determining whether an excess of book value over cost should be reflected by an adjustment of goodwill, an adjustment of the book values of other subsidiary assets, or a credit to consolidated capital surplus, there is growing tendency among accountants to set such items out separately in the consolidated balance sheet with some such title as 'Excess of book value of subsidiary stock at date of acquisition over cost thereof.' If this procedure is followed, the accountant is still faced with the necessity of classifying the item in the balance sheet; it is usually shown under the net worth caption, but this procedure is correct only if all assets of the subsidiary are properly valued; if the excess of book value over cost really means an over statement of the book value of subsidiary assets, the item should be excluded from net worth." Finney, op. cit., p. 291.

revised values into account in preparing the consolidated balance sheet are complex enough to warrant a short example. A more extended illustration of this and other phases of consolidation at the acquisition date will be found in the appendix.

On December 31, 1947, Par Co. acquired a 60 percent stock interest in Sub Co. at a cost of \$57,000. The following schedule shows the book values of Sub Co. on this date and the audited appraised values:

Analysis of Sub Co. Values
At Acquisition of Control December 31, 1947

	Book Values	Audited Appraised Values
Current assets	\$ 30,000	\$ 28,500
Plant assets (net)	80,000	102,000
Goodwill	10,000	-
	<u>\$120,000</u>	<u>\$130,500</u>
Current liabilities	\$ 10,000	\$ 9,900
Funded debt	40,000	40,600
Capital stock	55,000	-
Earned surplus	15,000	-
	<u>\$120,000</u>	<u>\$ 50,500</u>
Appraisal difference attributable to stock		<u>\$ 80,000</u>

Revisions of Surplus for Consolidation Purposes

Correction of earned surplus:		
Earned surplus per books		\$ 15,000
Decrease in current assets	\$ 1,500	
Less: Decrease in current liabilities	<u>100</u>	
Decrease in earned surplus		<u>1,400</u>
Earned surplus revised		<u>\$ 13,600</u>
Recognition of appreciation surplus:		
Increase in plant values		\$ 22,000
Less: Increase in value assigned to funded debt		<u>600</u>
Appreciation surplus		<u>\$ 21,400</u>

From the above analysis the figures may be derived for the consolidating work sheet in a fashion which will enable the figures to

be combined after one simple elimination entry.

Sub Co. Accounts to be Entered on the Consolidating Work Sheet
December 31, 1947

Current assets		\$ 28,500
Plant assets (net)		102,000
Goodwill (minority share of book value, .4 x 10,000)		4,000
Excess of acquisition price over appraised values of inventoriable assets minus debts (57,000 - .6 x 80,000)		9,000
		<u>\$143,500</u>
Current liabilities		\$ 9,900
Funded debt		40,600
Minority equity:		
Capital stock (.4 x 55,000)		22,000
Earned surplus (.4 x 13,600) as corrected		5,440
Appreciation surplus (.4 x 21,400)		8,560
Par Co. interest:		
Capital stock (.6 x 55,000)	\$33,000	
Earned surplus (.6 x 13,600)	8,160	
Appreciation surplus (.6 x 21,400)	12,840	
From increase in "goodwill" (9,000 - .6 x 10,000)	<u>3,000</u>	
Par Co. equity to be eliminated against investment in Sub Co. stock		57,000
		<u>\$143,500</u>

There may be some point in continuing the book value of goodwill at \$10,000 and setting up the excess of security cost over revised values at \$3,000. If the excess had been less than \$6,000, treating the goodwill at book value would require setting up a contra asset or a gain on purchase, a doubtful procedure.

The Acquisition Date

There is another complication which serves to make the whole process of cost allocation very troublesome. It was tacitly assumed above that all purchases of securities were made as of a single acquisition date. Negotiations may have required considerable time and values upon which the offer was based may have changed appreciably by the time the deal was consummated. To the extent that the time factor has

entered into the picture without recognition, it will be necessary for the accountant to record gains or losses on the purchase.

All of the shares may not have been acquired in one block, but may have been acquired from numerous small stockholders at various times and at various prices. The value of the excess earning power is almost indeterminate on any other basis than cost in such a situation. Purchase of stock in blocks will require a separate appraisal of the properties of the subsidiary at every purchase date and an allocation of the difference in the purchase price to the excess-earning-power factor. This may be simplified by an averaging process, attributing the purchases of a month or a quarter to the average of the beginning and ending balances if the assumption that revenues are fairly regular is justified.²⁰ In the extreme case, a parent may have held a percentage of stock giving it less than control for several years prior to the final acquisition of control. This method of attributing cost, however, is not suitable for properties other than intangibles unless an installment purchase be assumed, and even then the valuation procedure would involve an absurdity in the case of cash and receivables for example.

An adaptation of Kohler's²¹ procedure of using the last

²⁰"Ideally the cost of the purchases of each day should be compared with subsidiary book value as of such day, but this would require the spreading of the periodic profits of the subsidiary and may calculations. One possibility is to assume that the purchases of a particular month, for example, occur as of the middle of the month, and that the subsidiary value as of such date is the average of beginning and ending book figures." W. A. Paton, Advanced Accounting, op. cit., p. 771.

"In practice, when the stock is acquired in numerous small lots during a fiscal period, the purchases of shares are grouped and the computations of amounts to be eliminated are determined on the basis of balance sheets of the subsidiary at the nearest dates to such acquisitions." R. H. Montgomery, Auditing Theory and Practice, p. 517, N. Y., 1940.

²¹Op. cit., p. 65.

purchase date gives a reasonable answer to the problem. The following steps are required. Determine the cost of "goodwill" on each purchase date as suggested above; the sum of such values will give the total cost of "goodwill" to the parent company. At the date full control is acquired, inventory and value the assets and the liabilities other than "goodwill" factors. After adding the "goodwill" previously determined to the difference between the values of the inventoriable assets and the liabilities, applying to the total interest of the parent company, compare the total computed value of the parent company investment to the cost of the investment; any difference between these last two amounts can be traced to two causes, profits or loss of the subsidiary attributable to the earlier investments²² and change in the value of some phase of the subsidiary. The profit or loss can be reported as joint earnings in the consolidated statements, while the appreciation or declination in value can be represented in the stock equity section as an adjunct or contra to the parent company accounts.

For the method outlined to succeed the appraisal of the inventoriable assets must be very carefully verified. The only check possible is the examination of the appreciation or declination amount for indications of an amount not reasonably arising from changes in the subsidiary. The method will approximate the amount that would

²²If no profits of a subsidiary are assigned to the first holdings, "The amount shown for consolidated surplus can be regarded as correct only on the theory that Company A earned nothing on its ... (25%) investment during 1945; and the amount shown for goodwill can be regarded as correct only on the theory that the ... profit applicable to the 25% holding in 1945 was not income but was a return of part of the cost of the investment." Finney, op. cit., p. 308.

have been paid for the inventoriable assets at the time control became complete, not what was paid, and will show the actual cost of the "goodwill". Of course, the "goodwill" as thus determined will include the effects of gains or losses on security purchases. This procedure seems to give informative results, all that can be expected in such a complex situation. The assets and liabilities will be on a current value basis as nearly comparable to cost as is possible under the circumstances.

If there have been few changes in the subsidiary during the period of stock purchases, the procedure can be simplified by adjusting (for purposes of the calculation) the earlier acquisitions for retained earnings and then simply comparing the sum of all the costs of securities and accrued profits to the appraisal data at the date control is acquired.²³ The appreciation or declination assumed to be negligible will find its way into the cost of "goodwill".

Illustration of Purchases at Different Dates

Par Co. acquired a block of stock of Sub Co. on December 31, 1947, giving it a 30 percent interest at a cost of \$28,500, and another block of stock on December 31, 1948, giving it an additional 40 percent interest at a cost of \$49,500.

²³"It seems more reasonable, however, to make a single comparison as of the date on which control was finally obtained. No serious objections can be offered to this procedure provided no important changes occurred in the status of the subsidiary during the period of gradual acquisition." W. A. Paton, Accountants' Handbook, op. cit., p. 1083.

Analysis of Sub Co. Values

	Book Values		Audited Appraised Values	
	December 31		December 31	
	1947	1948	1947	1948
Current assets	\$ 30,000	\$ 50,000	\$ 28,500	\$ 48,000
Plant assets (net)	80,000	75,000	102,000	112,000
Goodwill	10,000	10,000	-	-
	<u>\$120,000</u>	<u>\$135,000</u>	<u>\$130,500</u>	<u>\$160,000</u>
Current liabilities	\$ 10,000	\$ 15,000	\$ 9,900	\$ 14,200
Funded debt	40,000	40,000	40,600	40,800
Capital stock	55,000	55,000	-	-
Earned surplus	15,000	25,000	-	-
	<u>\$120,000</u>	<u>\$135,000</u>	<u>\$ 50,500</u>	<u>\$ 55,000</u>
Appraisal difference attributable to stock			<u>\$ 80,000</u>	<u>\$105,000</u>

Revision of Surplus for Consolidation Purposes
December 31, 1948

Correction of earned surplus:		
Earned surplus per books		\$ 25,000
Decrease in current assets	\$ 2,000	
Less: Decrease in current liabilities	800	
Decrease in earned surplus		1,200
Earned surplus revised		<u>\$ 23,800</u>
Recognition of appreciation surplus:		
Increase in plant values		\$ 37,000
Less: Increase in value assigned to funded debt		800
Appreciation surplus		<u>\$ 36,200</u>

Determination of "Goodwill"

30 percent block	28,500 - .3 x 80,000	\$ 4,500
40 percent block	49,500 - .4 x 105,000	7,500
Total excess of purchase prices over appraised values		<u>\$ 12,000</u>

For the sake of simplicity it will be assumed that the "goodwill" need not be amortized. The next step is the determination of the amount of earnings assignable to the first holding.

Change in Value Assignment of the First Purchase

Appraisal difference 1948 attributable to Par Co., 70%		\$ 73,500
Total excess of purchase prices (as above)		<u>12,000</u>
Total value to be reported in consolidation		\$ 85,500
Cost of securities held (28,500 plus 49,500)		<u>78,000</u>
Increase in value of first holding attributable to retained earnings and appreciation of properties		\$ 7,500
Earnings assignable to the 30 percent holding		
Earned surplus corrected December 31, 1948	\$ 23,800	
Earned surplus corrected December 31, 1947	<u>13,600*</u>	
Earnings retained during 1948	\$ 10,200	
Less: Increase in depreciation arising from appraised value of plant of 1947 (assumed)	<u>2,000</u>	
	\$ 8,200	
Less: Loss from increase in value of bonds	<u>200</u>	
Adjusted retained earnings	\$ 8,000	
Par Co. share of adjusted earnings 30% of above		\$ 2,400
Par Co. share of appreciation during 1948		<u><u>5,100</u></u>
 Proof:		
Appreciation surplus 1948	\$ 36,200	
Appreciation surplus 1947	<u>21,400*</u>	
Difference	\$ 14,800	
Appreciation assigned to expense and loss above	<u>2,200</u>	
Appreciation during 1948	\$ 17,000	
30% of appreciation during 1948		<u><u>5,100</u></u>

*See illustration of the use of appraisal data earlier in this chapter.

Sub Co. Accounts to be Entered on the Consolidating Work Sheets
December 31, 1948

Current assets		\$ 48,000
Plant assets (net)		112,000
Goodwill (minority share of book value, .3 x 10,000)		3,000
Excess of acquisition prices over appraised values (as above)		12,000
		<u>\$175,000</u>
Current liabilities		\$ 14,200
Funded debt		40,800
Minority equity:		
Capital stock (.3 x 55,000)		16,500
Earned surplus (.3 x 23,800) as corrected		7,140
Appreciation surplus (.3 x 36,200)		10,860
Par Co. interest:		
Capital stock (.7 x 55,000)	\$ 38,500	
Earned surplus (.7 x 23,800 - 2,400)	14,260	
Appreciation surplus (.7 x 36,200 - 5,100)	20,240	
From increase in "goodwill" (12,000 - 7,000)	<u>5,000</u>	
Par Co. equity to be eliminated against the investment		78,000
Consolidated earned surplus		2,400
Consolidated appreciation surplus		<u>5,100</u>
		<u>\$175,000</u>

Reporting "Goodwill"

One company acquiring the stock of another by negotiating directly with the individual stockholders can expect the first purchases to represent the current market appraisal of the value of the earning position of the company. It can also be expected that as more and more securities are purchased in this fashion the price of the securities will continue to mount.²⁴ It is possible that an acquiring company may be coerced into paying an excess which can only be considered a part

²⁴Increasing costs of the later purchases should be considered. Newsweek for April 7, 1947, p. 44, tells of the attempt of the Canadian E. P. Taylor and his associates to gain control of the St. Lawrence Corp., Ltd., a pulp and paper combine. Attempts by this group to acquire stock pushed the price from \$6 to \$14.75 per share from September, 1946 to April,

of the capitalized excess earning power of the joint enterprise. The excess paid for a crucial block may even surpass the group excess earning power value attributable to the shares.

As calculated under the above procedures goodwill recorded on the books of a subsidiary is ignored. Reporting the joint position of the parent and the subsidiary when a minority exists will mean some adjustment of the recorded goodwill. The minority interest in the goodwill will be continued and if the parent company's "goodwill" cost exceeds the parent company's share of the recorded goodwill there is some point in continuing the whole amount as recorded with any excess of "goodwill" cost to the parent reported as a separate amount. If the "goodwill" cost to the parent is less than the parent's proportion of the recorded goodwill, an offset would be indicated rather than a reporting of negative goodwill or consolidation surplus. If the parent has paid less than the value of the inventoriable assets minus debt but the subsidiary has recorded goodwill, it may be well to have a resolution adopted to write off the recorded goodwill on the books of the subsidiary.

The cost of excess earning power deserves a title for reporting

1947.

"This goodwill value of \$9,000 attaches to the stock because it was purchased at a price of \$9,000 in excess of the book values of the proportionate interest in the net assets which it represents. It does not follow that the remaining stock would or could be purchased at the same price. Instances could be cited to illustrate the squeeze which a small minority interest is able to apply to a controlling interest which finds it necessary or expedient to acquire all the stock of a subsidiary." H. A. Finney and H. P. Baumann, "Consolidated Goodwill in Relation to Minority Interest," The Journal of Accountancy, XLIV, 462, Dec., 1927.

purposes.²⁵ If the value is carefully constructed and does not include other factors the titles, cost of consolidated goodwill attributable to patents and processes, and cost of consolidated goodwill unassignable are descriptive. The term consolidated goodwill has fallen into disrepute because it has been used to cover a multitude of factors. Such terms as "excess of cost over book value" and "consolidation excess" can cover only the cases in which compromises are introduced into the procedure to continue the book value of the subsidiary unchanged.²⁶ The excess as computed above includes no values attributable to inventoriable assets but may contain the effects of profits or losses on the purchase of the securities as well as errors made in valuing assets and debts. A suitable title might be excess of acquisition cost over value attributed to tangible assets.

Other Complexities

A few other matters are sometimes involved in assigning costs.

²⁵"A difficulty arises where the tangible assets of the subsidiary are reasonably stated on the subsidiary books when considered individually, but have a total book value in excess of their going-concern value in the particular setting in which they are employed. In this type of situation the difference between cost of subsidiary stock and the related book value is a blanket deduction applicable to subsidiary assets in general (exclusive of any current assets with an unquestioned realizable value equal to book figures), and specific adjustment of subsidiary books is hardly feasible." W. A. Paton, Advanced Accounting, op. cit., p. 757.

"...Where the net credit balance (negative intangible) applicable to all subsidiaries is substantial, as might occur in acquisitions made under distress conditions, it is preferable to treat such difference as additional capital in order that subsequent income may be charged with reasonable depreciation provisions." P. F. Brundage, Contemporary Accounting, Ch. 5, p. 5.

²⁶"When the excess of cost incorporated in the consolidated statement is a material amount, it may be advisable to disclose such amount, rather than include it as part of the asset amounts without explanation, if the spread between original cost of assets to the subsidiaries and the basis of their acquisition cost to the holding company group is significant information." Montgomery, op. cit., p. 516.

Some of the assets, particularly inventories, may have been obtained from the parent company at a profit to the parent company before control was acquired.²⁷ Objections have been raised to the assumption that the parent would be willing to buy its own merchandise back at sales price.²⁸ No question would arise, however, if exactly similar goods acquired from a competitor were involved. The mark-up was realized, an economically legitimate item, and the goods are a step nearer the consumer. Furthermore, there is no question of a fictitious price because the two companies were separate at the time of the sale.²⁹

The question of exchanging securities of the parent for the securities of the subsidiary is involved only to the extent that it may be difficult to determine the issue price of the parent company stock. In this case the cost of the subsidiary's securities, the key figure in the consolidation, will tend to be more doubtful.

A more difficult matter arises when the parent company acquires some of the shares by direct purchase from the subsidiary company. If

²⁷Staub, op. cit., p. 28.

²⁸"...a company buying the capital stock of another company, which carries on its balance sheet merchandise acquired from the first company would almost surely discount the value of such an inventory while determining the purchase price to offer for the capital stock." G. H. Newlove, from manuscript titled, "Consolidated Statements," ch. 3.

²⁹"On the other hand there is a special difficulty in attempting to eliminate any intercompany profit in a subsidiary's inventory at the date of acquisition. Such profit represents a part of the book value of the subsidiary stock, and is reflected on the books of the parent company in the investment account to the extent of the percentage of a stock acquired, in the same manner as all other elements of such book value." W. A. Paton, Accountants' Handbook, op. cit., p. 1094.

"If a transaction is not an intercompany transaction when it occurs, there seems to be no propriety in retroactively classifying it as such and thereby transferring a non intercompany profit of one year to consolidated profits of a subsequent year." Finney, op. cit., p. 277.

the price paid is in proportion to the assigned value of total assets, the solution will not be disturbed,³⁰ but if the price is more than the assigned values for the proportion acquired the difference will be a gain to the minority. A price less than the indicated proportion will be a loss to the minority and a gain to the parent which may conveniently, if somewhat inaccurately, be offset against goodwill. A much more extended discussion of a special phase of this problem will be found in the following chapter.

A serious problem exists if the subsidiary should have bonds outstanding which are convertible into common stock. Conversion of such bonds could bring about losses of value to the parent and would certainly weaken if not destroy its control.³¹ If the value of the stock into which the bonds are convertible exceeds the recorded value of the convertible bonds, the higher value should be used in the appraisal process unless there is some possibility of calling the bonds before conversion takes place. Fortunately convertible bonds are uncommon.³²

³⁰But the proportion of earned surplus assignable to an earlier interest will be. See E. A. Kracker, "Consolidated Financial Statements," The Journal of Accountancy, LXVI, 384, Dec., 1938.

³¹"...the Anaconda Copper Mining Company, includes in its consolidated statements only companies of whose capital stock it owns 75 percent or more. The 1928 consolidated statements did not include the Andes Copper Mining Company, which had been so included previously because 'the equity of Anaconda was decreased below 75 per cent, due to the conversion of the Andes convertible 7 per cent debentures.'" W. A. Staub, "Consolidated Financial Statements," Accountant, LXXXI, 732, Dec. 7, 1929.

³²"... it is probable that the number of these hybrid forms of convertible securities will increase because they cost the corporation nothing in interest obligation; yet they provide a means which enables the speculator to 'take a position' in the market with the least money investment. For this means the speculator will pay the corporation something." Dewing, op. cit., p. 245.

The accountant is often perturbed by the fact that major business transactions do not occur at the end of accounting periods. Control acquired within an accounting period will necessitate some shifting of the reports. It has been advocated that the income statements for the period be combined, even though the two enterprises were not associated for the whole of the period, to form a better picture of the joint operations.³³ No reporting method is entirely satisfactory, but it would seem that the facts of the association require that joint portrayal start at the inception of the association. If the income statement is to be useful it must show the results of joint operation under the common management of the ownership-control, particularly if it is presumed that there is an economic justification for the affiliation. On the other hand, it may be that the first fraction of a period is too soon to expect any changes to result from the joint control, and the extra labor involved in making a cut-off at the acquisition date might not be justified by the added information. Nevertheless, joint portrayal for the whole period is merely an expedient; it does not report the facts.

Full Imputation of Excess Earning Power

Of the various objections that may be raised to the above method of calculating the allocation of excess of cost over book values, inconsistency is the most valid. The cost implications of the parent company's purchases are used to completely revalue the inventoriable assets, resulting in an increase or decrease in the minority interest reported as appreciation or declination. No such attempt is made to

³³See E. J. B. Lewis, Consolidated Statements, p. 55, N. Y., 1942, and Finney, op. cit., p. 389.

revalue the excess earning power. The minority equity includes appreciation of the inventoriable assets but does not reflect the current valuation of patents and neither does an earlier investment of less than control. Of the consolidated "goodwill" of \$12,000 in the last illustration, \$7,500 represents the purchase of a 40% interest. If the 40% purchase were taken as a guide, "goodwill" might be represented at \$18,750 instead of \$15,000, (12,000 + 3,000). Full imputation would mean an increase in "goodwill" of \$3,750 of which \$2,625 would be the minority share.

It should be clearly understood that the \$7,500 above is highly tentative. The cost of the 40% investment is reflected as the value of the total items acquired. This cost is assigned to the individual items on the soundest basis possible, an audited appraisal, but it cannot be presumed that the assignment is free from error. All errors in appraisals of the individual inventoriable assets have a complementary effect upon the "goodwill". If all of the items are slightly undervalued, "goodwill" will be greatly overvalued, and if the purchase of the last block had been 10% instead of 40%, the errors would be multiplied tenfold.

The price paid for securities may be a "good buy" or a "poor buy". Any mistakes made in arriving at the price are automatically reflected in the residue, "goodwill". To eliminate the affect of this type of error the excess earning power would have to be appraised, but such appraisals as this are highly inaccurate.

If stock is acquired in blocks at varying prices, the cost of the final block that gives control may not be based on the total value of the subsidiary. With varying prices paid over a short period of time,

"goodwill" imputation would depend upon the price selected as typical.

There probably are cases in which the parent company acquires control of the subsidiary not for the earnings of the subsidiary alone but for the increased earnings the control of the subsidiary is expected to produce for another member of the affiliation or for the group of companies.³⁴ If this is the case the parent may pay more for the subsidiary than the earning power of the subsidiary would justify.³⁵ The excess paid would be in the nature of a cost of consolidated "goodwill" and not assignable necessarily to any one of the companies.³⁶

³⁴"There is also the possibility that affiliation is effected for the purpose of discouraging competition or strategically improving the position of the controlling corporation and that a premium paid for the stock acquired may be explained from this standpoint." W. A. Paton, Advanced Accounting, op. cit., p. 756.

³⁵"...in a recent case concerned with the establishment of the price at which the New York Central Railroad Company should purchase the Ulster & Delaware Railroad, the Interstate Commerce Commission was faced with the question whether the 'commercial value' of the latter railroad should be based on (a) the value of that railroad as an independent line, or (b) the value of that railroad as a part of the New York Central system, or (c) some compromise between these two values ... But in a purchase as distinct from a condemnation, neither business practice nor legal tradition adheres to a doctrine of indemnity. Instead there is a tendency to compromise between the lower value of the property to the vendor and the higher value to the purchaser. Some such compromise was accepted by the Interstate Commerce Commission in the case here referred to." J. C. Bonbright, Valuation of Property, p. 236, (in reference to 175 I. C. C. 65, 1931), N. Y., 1937.

³⁶"It may be that the parent company paid the premium to obtain control of the subsidiary in order to increase the profits of other companies in the group; if this is true, the premium was not paid for a goodwill inherent in the new subsidiary as a separate corporation and the minority shareholders are therefore not entitled to participate in it. ... If, with evidence relative to undervaluations of tangible assets adequate to support adjustments of the subsidiary's books, the adjustments are not made therein but are applied to the consolidating working papers, it seems proper to give the minority interest the benefit of its share of the adjustments." Finney, op. cit., p. 297.

Once goodwill is on the books, the accountant is faced with the problem of continuing valuation. It is literally impossible to make an accurate assignment of goodwill to the periods of its usefulness. Goodwill must be put on the books if it is purchased but it need not be recognized in the accounts if it came about as an appreciation factor.³⁷ Recognizing appreciation of goodwill is a matter for the independent analysis of the investor in view of current investment alternatives.³⁸ Any attempt to record goodwill on any other than a cost basis forces the judgment of the accountant on an investor who is better qualified to know his own earnings requirement than is the accountant.

The majority and minority interests are on a comparable basis in all respects except with respect to the value basis of excess earning power. The several purchases of the parent are also divergent in this respect. If the excess paid by the parent is well displayed, the minority and majority interests can be readily reconciled and compared on the balance sheet.³⁹ All income sheet comparisons will be on a comparable

³⁷"To add to the consolidated goodwill additional goodwill of the minority interest to bring that goodwill to the proportionate value of goodwill paid for in acquiring the controlling interest would merely increase an asset whose value is often quite 'nebulous', and which is generally ignored in the consideration of a consolidated balance sheet, although of necessity included as an asset." Walton and Langer, op. cit., L. 33-2.

³⁸Determination of excess earning power is subject to at least three errors of estimates; (1) average earning power of the industry, (2) earning power of the enterprise actual and potential, and (3) rate of capitalization of the excess.

³⁹"There shall be set forth in a note to each consolidated balance sheet filed a statement of any difference between the investment in subsidiaries consolidated, as shown by the parent's books, and the parent's equity in the net assets of such subsidiaries, as shown by the books of the latter. If any such difference exists, there shall be set forth the disposition made thereof in preparing the consolidated statements, naming the balance sheet captions and stating the amounts included in each." Securities and Exchange Commission, Regulation S-X, Rule 4-05, Washington, 1940.

basis except for amortizations of the excesses and these charges will necessarily be separately displayed and deducted. In the final analysis the above method does not distort relationships materially, and it does give useful and reliable data for individual analysis.

It may be complained that the method goes too far. The minority is not a party to the investment of the parent. If it is wished to portray the minority position as if nothing had happened, there can be no serious objection to leaving the subsidiary books on the same basis as before,⁴⁰ although there will be more work required in preparing the consolidated statements. The minority could then rely on the individual statements of the subsidiary to show trends of profitability and security; in the end the minority must rely on such statements as these. On the other hand, the minority should have a general interest in the consolidated statements, for these statements show the facts of the association. The subsidiary statements reported on an original cost basis are not components of the group statements. Comparisons of the individual to the group of which it is a part require that the two be reported on a comparable basis. Nevertheless, the over-all effect of value changes can be approximated from the minority appreciation account, in simple combinations at least, and the details of these value changes will be of little importance for the type of analysis the minority will

⁴⁰"Concentration of a controlling interest or even of all of the stock of a company in the hands of a single holder, individual or corporate, is not, after all, strictly equivalent to the sale of the enterprise. Without actual merger the subsidiary corporation persists as a legal entity, and there should be no blinking of this fact. As a rule the transfer of shares where the corporation itself is not a party to the transaction is conceded not to affect the company books, and it may be urged that this position should be maintained regardless of the extent to which there is a shift of stock ownership." W. A. Paton, Advanced Accounting, op. cit., p. 758.

undertake.

The majority tends to gain more or lose more from the operation of the subsidiary than does the minority and the majority has selected the management. In any doubtful case the needs of the majority should govern but not to the extent of leaving the minority in the dark. The following out of a strict original cost approach might result in reporting three values for all of the plant items, the minority cost, the original purchase costs of less than control, and the final purchase cost. It would be much more logical to split the balance sheet into vertical segments to report the different cost bases than to take 1/2 a building at \$140,000, 1/4 at \$79,260, and another 1/4 at \$99,075, and add them together. Apparently no one seriously proposes this.⁴¹ Reporting combinations of values would indeed destroy all comparability between the minority and the majority; a separate balance sheet for minority proportions would be slightly less confusing than this.

The position here taken is that revaluing the inventoriable assets is necessary in order for the consolidated balance sheet to reveal the majority position, to place the majority and the minority on a comparable basis, and to reflect values in a sensible manner. It is also insisted that the value of excess earning power imputed from the excess of security costs over appraised values has extremely doubtful validity.

Some comment may be in order regarding full imputation based upon consolidation excesses. If for some reason it is considered

⁴¹W. A. Paton, Accountants' Handbook, op. cit., p. 1079-80.

impossible to revalue the inventoriable assets, and if the subsidiary book values are carried over to the consolidated balance sheet, the difference between the cost of the securities and the proportion of the book values thus acquired must be reported.⁴² In the illustration previously referred to, \$49,500 purchased a 40% interest in \$80,000, or \$32,000, showing an excess of \$17,500. In the event that the accountant is required to impute the total value from this figure, the minority appreciation would be \$13,125 instead of the \$10,860 in the example. This increase in minority equity would be counterbalanced in this case by an increase in consolidation excess. On the face of it, the recognition of appreciation of this sort does not serve to clarify the relationships. The minority can interpret the situation very adequately by treating the consolidation excess of the parent as a contra account to the consolidated capital stock, a very simple calculation. A simple footnote will suffice to show the majority the effect of full imputation. All of the above objections to imputing the full amount of goodwill apply with equal force to this excess, at least to the extent that the item includes an appreciable amount of goodwill and is accounted for as goodwill. In many cases there will be little certainty as to just what the item does contain, but it is likely to contain many

⁴²On consolidated balance sheets the difference between the investment cost and the book equity is in practice variously disposed of. An excess of investment cost has at time been merged in an undisclosed amount with recorded goodwill, added to tangible fixed asset accounts, shown separately, or subtracted from the combined capital stock and surplus accounts. An excess of book equity at the date of acquiring control has been merged in an undisclosed amount with 'capital surplus' or paid-in surplus, subtracted from tangible fixed asset accounts, or shown separately. In some instances, both 'goodwill from consolidation' and 'capital surplus from consolidation' have appeared on the same consolidated balance sheet; in other instances they have been merged." Kohler, op. cit., p. 66.

different factors. The best rule to be used in determining whether or not to impute extra value from this makeshift figure would be that full imputation is acceptable if the amount of the excess paid is ascribable to values of tangibles⁴³ but not acceptable if there is uncertainty that the values reside in the subsidiary or if it merely adds to goodwill.

Summary

Whenever a company buys an interest in another company already in existence, the amount paid for the interest is not likely to correspond to the book values recorded for the second company. The treatment of the difference must depend upon the reasons for the difference.

Establishment of sound values for consolidated statements can only be accomplished by undertaking a comprehensive audited appraisal of the inventoriable assets and a reconstruction of the values assigned to the debts and by relating the results of this appraisal to the price paid for the securities. An amount paid for the securities in excess of the value of the inventoriable assets minus the value assigned to the debts attributable to the securities purchased should be reported as an intangible. This excess may be considered to be the price paid for extra earning power, and an attempt should be made to allocate the amount to factors having limited lives and factors having unlimited lives. In

⁴³"The case for a complete adjustment is especially strong where the reconciliation is conceived in terms of particular asset values. Thus if the price paid for the stock in the illustration is based on an appraisal which shows an accrued depreciation exceeding the amount booked by \$1,666.67, it would seem somewhat ridiculous to present a consolidated report in which the increase in allowance for depreciation is restricted to \$1,500.00." W. A. Paton, Advanced Accounting, op. cit., p. 775.

view of the fact that the excess will be affected by errors in setting the proper price for the securities, by errors in valuing the assets, and by errors in assigning values to prior obligations, it is necessary to distinguish this item from other intangibles. If the values of the inventoriable assets and the debts on the books differ from the appraised values at the time of the acquisition, adjustment of the books is probably justified, but if the books are not adjusted, it will still be possible to use the revised values in the consolidated statements.

Care should be taken to relate stock purchases to the revised values at the time of purchase. Purchases giving less than control will be reported as investments until additional purchases give control. With control established, the first purchases may be related back to the date of their acquisition to determine the cost differences and to account for changes in value during the period the securities were held.

Revaluation of the inventoriable items seems necessary in order to reveal the parent company's position, to place the parent company's holdings and the minority's holdings on a comparable basis, and to reflect values in a sensible manner, but a corresponding revaluation of intangibles on the basis of the purchase seems inadvisable. To impute an intangible value for the minority interest from the excess paid is not to report a fact but a speculation - a speculation that would have little meaning even if it were not subject to errors.

CHAPTER IV
SECURITY COST AND BOOK VALUE DIFFERENCES
AFTER ACQUISITION

Once the cost of securities and the underlying values have been reconciled, the principal differences in these two values evolving in subsequent compilations will arise from the profit-making activities of the subsidiary. There may be other changes in the relationships of security cost to underlying values, such as revaluation of the subsidiary's assets, revaluation of the parent company's investment account, changes in the amount of the subsidiary stock held by the parent, changes in the amount of the subsidiary stock held by the minority, and others. Any change in either the investment account of the parent or the total of the values underlying this account will require attention in the preparation of the consolidated statements.

Accounting for the Original Excess Cost

There will generally be no unusual problems in the assignment of the original excess of cost to future activities of the subsidiary if such excess is recorded directly in the accounts affected on the books of the subsidiary company. The excess attributable to intangibles will probably not be so recorded but, in any event, will require special treatment. If the books of the subsidiary do not reflect the effective purchase price of the items to the parent company, preliminary adjustments of the figures reported for the subsidiary will need to be made before the figures are carried to the consolidating work sheets. Any errors, not matters of valuation,

should be corrected directly in the records of the subsidiary.

In the asset picture, there are two main types of items, those one step removed from cash and stated in terms of cash realizable values, and those stated in terms of acquisition cost requiring further activity before the realizable value is ascertainable. In the first class, will be found receivables and securities. In the second class, will be found inventories, depreciable property, and prepayments. Accounting for the excess of purchase price will be similar for all items in the first group and for all items in the second group. In all cases, a realization of an appraisal difference will mean a realization of the minority appreciation or declination which will be recorded by transferring the amount from the minority appreciation account to earned surplus. In all other respects the treatment of value differences assigned to operations will proceed as outlined below regardless of the size of the minority interest.

There are several possible appraisal differences in the receivables and securities sector which should be traced to the cash realization. It may not be amiss to transfer a difference attributable to estimates of collectibility of short term receivables to the first year of joint operation. This will involve the elimination of the appraisal adjustment of allowance for uncollectibles against the current charges of the subsidiary. The charge made to bring the allowance to its proper year-end balance together with special write-offs or recoveries will include the effects of the errors of the acquisition date. Since the parent is an associated owner for the period, the balances at the end of the period will represent the parent

as much as the subsidiary. Probably differences arising from errors in estimating sales discounts and sales returns should be considered errors, but in any event these differences will be similar in their treatment to that of collectibility. If interest has been imputed to the receivables, collection will involve realization of this difference and it must be reported as revenue.

Failure by the subsidiary to accrue interest and dividend declarations on securities held amounts to an error to be corrected in the accounts. There may well be differences in valuation of securities that will require assignment. An interest bearing security revaluation will necessitate a spreading of the difference in discount or premium over the remaining life of the item. Thus a security overvalued on the books will be assigned an extra discount (or a smaller premium) to be accumulated periodically as extra revenue for the consolidation. A difference in the value of stock investments will need to be carried until the disposal of the items and treated as an adjustment of the recorded gain or loss on the sale.

Special long-term receivables such as construction contracts partially completed and installment accounts will be appraised on the basis of the costs to be incurred and normal earnings. Appraisal differences must be assigned as adjustments of revenue realisations.

Appraisal differences allocated to items to be assigned as costs of obtaining revenues often involve complicated analyses. A difference in inventory value must be carried in the consolidation until the inventory is disposed of to customers or scrapped. As the goods are sold the difference becomes an adjustment of the cost of

goods sold in the joint portrayal. Meanwhile, the inventory may have changed its form, involving the tracing of the difference through from raw materials to finished goods. Determination of the cost of sales returns will also be slightly more complicated to the extent that the goods returned were on hand at acquisition. When the goods on hand at the acquisition date are finally disposed of, probably within the first year, the parent will be on the same value basis as the subsidiary. There is not likely to be any appraisal difference for such other current items as prepaid expenses. If there should be material changes in rates of insurance or rent, the difference can be assigned to joint operations quite easily by adjusting the current charges to expense to absorb the appraisal difference.

The items in the plant section are of two types, non-depreciable land, and depreciable buildings and equipment. Other properties of this type but not a part of plant can also be considered in this same connection. Any difference attributable to land will continue as a consolidation adjustment until the land is disposed of or revalued. Buildings and equipment, on the other hand, have terminable existence. As depreciable property is employed to produce revenues for the firm the cost of the property is charged to the goods or services produced. Thus a cost difference will require an adjustment of the charges to goods or services.¹ A simple charge, such as that made to administrative

¹Our American practice has registered progress, especially in the last decade, from an earlier and more confused situation as regards the treatment of these differentials, to a stage where this factual portrayal is more nearly attained; but we still have work ahead in further rationalization of our accounting procedure on this subject. For example, if the 'debit' differential is in fact an element in the valuation

expense, will merely need adjustment periodically to absorb the amount of the difference over the amount of the remaining life of the item. If the current charges attach to goods, it will be necessary to trace the adjustment through the various stages of production. The calculations must be made in accordance with the appraisal which may have changed the value basis of an item and its estimated life. Any difference between the recorded charge and the revised charge will be adjusted against the allowance for depreciation as revised. As in all other cases this correction can be considered realized appreciation to the extent of the minority share. Depletion calculations and adjustments will be made in a similar fashion.

There are numerous miscellaneous assets not covered above, such as leaseholds,² patents, franchises, goodwill, investments in a subsidiary, investments in the parent company, and others. The last two of these will be treated in another connection (see Chapter VIII). The first three items are generally absorbed as operating expenses through their lives. Adjustments for appraisal differences will correct these charges in a similar manner to depreciation mentioned

of plant property, in other words, is merely a part of the cost of plant property to the parent company, it should undergo amortization through provision for depreciation, something which is not of common occurrence." E. A. Kracke, "Consolidated Financial Statements," The Journal of Accountancy, LXVI, 382, Dec., 1938.

²"Assume the case of a subsidiary company owning nothing except a leasehold which stands on its books at an amount equal to its share capital, say £100,000. Suppose that the shares of the subsidiary company stand on the books of the holding company at their cost of £300,000. Provision for amortization of the leasehold should, I think, be computed on the basis of £300,000, one-third of the charge being taken up on the books of the subsidiary company and the remainder on the books of the holding company." A. W. Wyon, "Holding and Subsidiary Companies - Accounting Principles Involved in the Treatment of Earnings and Valuation of Holdings," Accountant, LXXXIX, 224, Aug. 5, 1933.

above except that the amortization will be a direct reduction of the item rather than an adjustment of a contra account. The treatment of the difference set up as goodwill or acquisition excess requires special study.

It will be noted that the extended illustration in the appendix shows a separate value of each intangible for the majority and the minority. No appreciation of value (or declination) was attributed to the minority for such items. To the extent that amortization seems justified, the charges could be made on an over-all basis for the lower of the two values, the value on the books or the appraised value. The amortization of the difference should be assigned as a direct deduction from the returns of the party showing the higher value.

Amortization of goodwill is a controversial point.³ It is difficult to think of any item as having indefinite life; even site

³"So long as the relationship between parent and subsidiary remains unchanged, acquisition goodwill is usually carried unaltered into all subsequent consolidated balance sheets. This procedure is consistent with the practice of treating goodwill as a permanent investment rather than as a terminable annuity. If, however, the position is taken that goodwill, in the case of an individual corporation, should be written off within a stated period, then consolidated goodwill should accordingly be amortized against surplus. Similarly if the excess of cost of investment over book value of stock acquired is based upon an unrecorded revaluation of specific tangible resources of the subsidiary the treatment of such excess in the consolidated statement should be consistent with the subsequent history of the tangible resources involved." W. A. Paton, Accountants' Handbook, p. 1080, 3rd ed., N. Y., 1943.

"...any goodwill, overvaluation of assets of subsidiary, advantageous purchase of stock of subsidiary, or purchase at less than book value because of low earning power is stated the same in subsequent consolidated balance sheets as in the consolidated balance sheet at date of acquisition." S. Walton and C. H. Langer, Advanced Accounting, L 34-3, Chicago, 1934.

"The Commission has adopted no general rule as to the amortization of goodwill. However, in those cases in which a registrant has

value of land tends to change as time passes. In the case of goodwill there is a special reason for desiring amortization. The goodwill cost of the parent at acquisition varies from goodwill cost of the subsidiary, but the cost of maintaining a favorable earnings position after the parent is in the picture is the same for both the parent and the subsidiary. Once the value existing at the origin of the association is exhausted, the underlying value of earning power is purchased just as much by the parent as the subsidiary. To continue to report a difference of cost when the item to which the difference applied is gone, does not seem realistic, particularly when there is a harmony of costs with

retained 'goodwill' indefinitely in its accounts, the staff has inquired into the propriety of this accounting treatment. As a result of an analysis of the nature of the account a number of registrants have undertaken programs of amortization which will result in charging the goodwill to income or, in some cases, earned surplus, over a reasonable number of years.

"...it was argued that since the item had not declined in value there was no need to write it off; that the write-off was a matter of conservatism and that it could therefore go against capital surplus. It is clear, however, that if such an asset were to become worthless it would then have to be written off. At such time the loss involved would clearly be chargeable to earned surplus. Preferably, of course, it should already have been provided for through prior charges to income. Under no circumstances would sound accounting principles permit such a loss to be charged to capital surplus. On these grounds, the Commission's staff has, for a number of years, taken the position that a write-off of goodwill to capital surplus was improper, the one exception being those cases in which the goodwill, when originally established, was fictitious and was offset by inflated credits to capital surplus." W. W. Werntz, Contemporary Accounting, ch. 38, pp. 5, 6, American Institute of Accountants, N. Y., 1945.

"The cost of terminable patent rights is clearly subject to amortization; the cost of goodwill or any other type of general intangible property may or may not be subject to amortization, depending on the circumstances. Where the term of life is indefinite and there is no measurable course of decline in value, adoption of a definite plan of amortization is not required." W. A. Paton, "Cost and Value in Accounting," The Journal of Accountancy, LXXXI, 196, March, 1946.

See also Chapter I, footnote 46 of the present study.

respect to the item that actually exists.⁴

There are a few adjustments that may need to be made in connection with liabilities. Implicit interest calculated for the current items must be taken as interest charges for the joint portrayal. A difference arising from purchase discounts available at acquisition not recognized by the subsidiary will be offset against purchase discounts or added to discounts lapsed. Revalued long-term debt will necessitate a revision of the discount or premium and subsequent adjustment of interest charges as this difference affects the discount accumulation or the premium amortization.

If the subsidiary assets and equities are not revalued at the time of acquisition but the whole difference in acquisition price is reported as one amount, the adjustments of the following periods are at once simpler and more complicated. All of the adjustments mentioned above will be made in the same manner except they will all affect the one excess rather than a specific excess. The difficulty comes in the discovery of what has happened to the excess in the period. Probably some arbitrary assigning method will have to be used in amortizing the total excess.⁵ It should be noted, however, that amortization is no less important in such a case.

⁴"Goodwill is recognized only in connection with the acquisition of a going business, in which case it represents the difference between the purchase price and the value ascribed to the net tangible assets acquired. It is not the Corporation's general practice to amortize items carried in this account." General Motors Corporation, "Annual Reports," p. 36, 1946.

⁵"Therefore, when the depreciable assets are kept at their original costs in the accounts of the subsidiary, a supplemental allowance should be made in the accounts of the parent company for the difference between the full depreciation allowance and the amount which

If the appraisal used for reporting purposes also served as the basis of determining the price paid for the securities of the subsidiary, there would be no question as to how the excesses of cost over book value should be accounted for. The values assigned to the items would be the costs of the items and failure to realize such costs in operations would simply mean a loss in the joint portrayal. Since the price paid for the securities may not have been determined in this fashion, it is likely that the appraisal is wrong in some respects. Whenever errors in the appraisal are detected, it will be necessary to make a retroactive adjustment of the intangibles and minority appreciation.

For the joint statements, the costs incurred by the subsidiary before control was acquired do not necessarily represent costs for the group. Failure to assign the group costs to operations may result in gross misstatements of profits or losses.⁶ A subsidiary acquired by a parent in 1947, but which acquired its property in 1934 on a very low price level, may make what appears to be a very nice profit. Investigation may show that if operating expenses were adjusted to the parent's

is provided on the books of the subsidiary. The supplemental allowance in the accounts of the parent company will naturally be set up only with reference to the proportionate ownership of the parent company." W. A. Staub, "Consolidated Financial Statements," Accountant, LXXXI, 739, Dec. 7, 1929. He is apparently referring to an investment account adjusted for subsidiary changes rather than on a cost basis.

⁶"If an excess of cost over book value at acquisition does not represent a payment for goodwill, but represents in effect a payment for subsidiary assets at a price in excess of their book value, the traditional treatment of the excess as goodwill (or the more recently recommended procedure of showing it as an excess of cost over book value) will probably result in an overstatement of consolidated net assets." H. A. Finney, Principle of Accounting Advanced, p. 295, N. Y., 1946.

cost basis the subsidiary would show a loss.⁷ From the standpoint of the individual companies, dividends based on such a profit would amount to liquidating dividends for the parent and should probably be treated as such. Wherever there is a wide divergence of costs, a reconstruction of the individual subsidiary statements to reveal the parent's position would be highly enlightening.

Illustration of Accounting for Excess Cost

A simple example will help to illustrate the above analysis of the application of excess costs to revenues. Par Co. acquired an 80% interest in Sub Co. January 1, 1947, for \$70,000. An excess over

Sub Co.
Balance Sheet
December 31, 1947

<u>Assets</u>		<u>Equities</u>	
Receivables	\$ 16,000	Current liabilities	\$ 16,000
Less All. for bad debts	1,000	Mortgage bonds	\$50,000
Net receivables	<u>\$ 15,000</u>	Premium	<u>2,000</u> 52,000
Other current assets	25,000	Total debt	<u>\$ 68,000</u>
Total current assets	<u>\$ 40,000</u>	Capital stock	\$50,000
W Co. bonds (Par \$10,000)	9,000	Earned surplus	
Land	10,000	at acquisition	19,800
Building cost	\$50,000	Earned surplus	
Less Allowance	20,000 30,000	current year	<u>1,200</u> 71,000
Equipment cost	<u>\$70,000</u>		
Less Allowance	<u>30,000</u> 40,000		
Patents	10,000		
	<u>\$139,000</u>		<u>\$139,000</u>

⁷"...in many cases the premium paid by a holding company for the shares acquired in a subsidiary will be represented to some extent at all events, by the acquisition of goodwill, but wherever provisions for amortization of depreciation are based upon the book values of assets, those values should be ascertained by reference to the price paid by the holding company rather than to the figures at which the several wasting assets are standing in the books of the subsidiary company. If the point is overlooked, profits of the holding company may be overstated and opportunity will arise for abuses through the formation of subsidiary companies formed to acquire from a holding company properties at values materially less than their true cost." Wyon, op. cit., p. 224.

Sub Co.
Income Statement
For the Year Ended December 31, 1947

Revenues

Sale of merchandise (net of disc. & bad debts)	\$100,000	
Profit on the sale of Z Co. stock	1,400	
Interest earned on W Co. bonds	500	
Revision of allowance for bad debts (recovery on acct.)	600	\$102,500

Expense

Merchandise cost of sales	\$ 80,000	
Building depreciation	2,000	
Equipment depreciation	7,000	
Patent amortization	1,000	
Other selling and administrative expense	9,000	99,000
Net income to investors		\$ 3,500
Interest charges on mortgage bonds		2,300
Net addition to surplus (Earned surplus current year)		\$ 1,200

book value of \$14,160 is discovered by comparing the cost with the stock equity (\$50,000 plus \$19,800) indicated in the accompanying balance sheet. The net book value of tangible assets arrived at by deducting the \$11,000 patent cost (\$10,000 plus the \$1,000 amortization for 1947) is \$58,800, and Par Co. cost exceeds 80% of this figure by \$22,960. This excess over book value of tangible assets is accounted for as follows:

Changes in values from audited appraisal

Excess provision for bad debts	\$ 660	
Increase in value of Z Co. stock (sold in 1947)	1,100	
Increase in value of W Co. bonds	440	
Increase in building cost basis (net)	4,000	
Increase in equipment cost basis	8,000	
Decrease in equipment depreciation	2,000	
Total increase in value of assets	\$16,200	
Increase in mortgage bond premium	1,100	
Net effect of appraisal January 1	\$15,100	

The \$22,960 excess of the purchase price over the book value of tangible assets may now be accounted for by

Total excess	\$22,960
Attributable to net changes in values (as above)	
.8 x \$15,100	12,080
Attributable to intangibles	<u>\$10,880</u>
Appraisal shows the patents to be worth \$9,000 on January 1. Par Co. share of this is 80%	7,200
Attributable to general excess unassigned	<u><u>\$ 3,680</u></u>

The recording of the above appraised value in the joint statements will require that the minority be assigned 20 percent of the above \$15,100 appreciation or \$3,020. Of course, the operations of 1947 will bring about a realization of a portion of this appreciation:

Recovery on accounts amounted to only \$600 instead of the \$660 anticipated but the \$60 difference may be attributed to 1947 conditions and the full \$660 considered realized	\$ 660
The Z Co. stock sale of 1947 justified the revaluation	1,100
Amortization of the W Co. bond discount (straight line absorption of the increase over eleven years)	40
Increase in depreciation (explained below)	1,250
Realization of increased values	<u>\$ 3,050</u>
Realized declination - Amortization of increase in mortgage bond premium (11 year)	100
Net realization of appreciation	<u><u>\$ 2,950</u></u>

Since the minority has a 20 percent interest, \$590 of the appreciation applies to the minority and must serve as the basis of a transfer from appreciation surplus to earned surplus. The minority earned surplus is computed by adding to the \$3,960 minority surplus January 1 the realized amount, \$590, and deducting \$330 of loss (see revised income statement) and \$20 of the minority patent (of the \$900 charge \$180 applied to the minority instead of \$200 out of the unrevised \$1,000 charge) value which was charged off on the books but not on the revised income statement.

The buildings had a total life expectancy of 25 years of which 9 years had elapsed on January 1. The net book value on January 1 was thus \$32,000 which must be revised to \$36,000. Since there are 16 years

to run, a yearly depreciation of \$2,250 is called for and a cost basis of \$56,250 may be imputed as well as accumulated depreciation to this point of \$20,250. The equipment depreciation would be complicated by many additions and disposals of items in the normal case. It may be assumed for the present purposes that the revised values of equipment adjusted for extended lives produced an extra charge of \$1,000 for the year.

The following revised statements take into account the effects of the above adjustments upon the book figures submitted earlier:

Sub Co.
Revised Balance Sheet
December 31, 1947

<u>Assets</u>		<u>Equities</u>	
Total current assets		Current liabilities	\$ 16,000
as above	\$ 40,000	Mortgage	\$50,000
W Co. bonds (par \$10,000)	9,400	Premium	3,000
Land	10,000	Total debt	\$ 69,000
Building cost	\$56,250	Min. Cap. Stk.	\$10,000
Less allowance	22,500	Min. E. Surplus	4,200
Equipment cost	\$78,000	Min. Appreciation	2,430
Less allowance	29,000	Consolidated E.	
Minority patent cost	2,000	Surplus	(1,320)
Majority patent cost	6,480	Acquisition	
Consolidation excess	3,680	Equity	70,000
	\$154,310		85,310
			\$154,310

Sub Co.
Revised Income Statement
For the Year Ended December 31, 1947

Revenues		
Sale of merchandise	\$100,000	
Profit on sale of Z Co. stock	300	
Interest earned on W Co. bonds	460	\$100,760
Expenses		
Merchandise cost of sales	\$ 80,000	
Building depreciation	2,250	
Equipment depreciation	8,000	
Patent amortization (on \$9,000)	900	
Other selling and administrative	9,000	
Total expenses	\$100,150	
Loss on 1946 accounts receivable	60	100,210
Net income to investors		\$ 550
Interest charges on mortgage bonds		2,200
Net deduction from surplus - current year		\$ 1,650
Majority share of loss 80%	\$ 1,320	
Minority share of loss 20%	330	
Total loss	\$ 1,650	

Subsequent Revaluations

The reconciliation of the security value with the book values will be disturbed if either the securities or the book values are adjusted to reflect a change in the condition of the subsidiary. Revision of the securities on the books of the parent company to conform to "ultimate realization"⁸ or the investment aspects of the association would necessitate reversal of such revision before consolidation of the statements or adjustment of the values of subsidiary items to correspond to the revised securities account. Any revaluation of subsidiary book values will change the relationship of such values to the carry value of the securities, unless the latter is changed to agree with the revaluation, and reconciliation can only be accomplished by taking up the adjustment on the consolidated statements or by reversal of the subsidiary adjustment. The fact that control

⁸This concept is developed by E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 63-76, March, 1938.

is exercised by the parent may indicate that a revision on either side is intended to be reflected on the combined reports.⁹

A fundamental change in the subsidiary forming the basis for a quasi-reorganization of the accounts to coincide with the new conditions should probably be accompanied by a revision of the value basis of the securities.¹⁰ This may be an ideal point to clear any remaining balance in cost excesses. With corresponding adjustments on both sets of records, the value bases should be brought into agreement without damage to the portrayal of the minority interest or to the legal concept of separate entities. In any event, this type of revision will require that the consolidated earnings derived from the subsidiary be displayed in a fashion that will reveal the point of origin of the amount, particularly if the adjustment involved a write down against capital.¹¹ It

⁹"A concern which has been keeping its Investment account by either one of the orthodox methods may, due to a depression, write off a large part of the Investment account against Profit and Loss or Earned Surplus. In such cases, the arbitrary adjustment to the Investment account should be reversed and the eliminations should be made upon the orthodox method employed prior to the arbitrary adjustment. The orthodox methods will bring actual losses on the consolidated balance sheet. If there is danger of serious loss in the future, a special contingency reserve should be established by the parent." G. H. Newlove, from manuscript entitled, "Consolidated Statements," ch. 4.

¹⁰"It has long been recognized in accounting that investments in controlled companies may properly be carried in the parent's accounts at cost despite market fluctuations and even despite the presence of occasional operating losses of subsidiaries in given years. This principle has, however, been consistently coupled with the admonition that evidence of probable loss must be given due attention, and where such evidence points to an apparently permanent decline in the value and earning power of the underlying properties, the company holding such investments should recognize and make provision for the loss either by writing down the investment or by setting up a reserve therefore." Werntz, *op. cit.*, ch. 38, p. 4.

¹¹"A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus will be carried through a readjustment in which some losses have been charged to capital surplus." American Institute of Accountants, "Quasi-reorganization or Corporate Readjustment," Accounting Research Bulletin, No. 3, p. 26.

is curious that a downward revision of values against capital in a case in which the parent had paid less than book value will require no dating of the surplus on the consolidated statements except for the minority interest, unless the revision exceeded the original cost difference. In the opposite case, if the parent paid more than book value, a downward revision of the book values will necessitate a larger revision for the consolidated statements.

Quasi-reorganization may be undertaken on a broader base than a single subsidiary. An over-all reorganization could be approached from the standpoint of the parent company, revising the values of the parent and all of its subsidiaries to conform to a fundamental change in the entire set of affiliated companies. A complete restatement of the component values would be indicated. The entries recorded in actual accounts, however, might not go beyond the parent company's books, for the position of subsidiary companies as separate companies may not have changed.

The consolidation procedures involved in the case of re-valuation are simpler than those required in the case of the original consolidation of a new subsidiary but more complex than routine consolidation of an existing subsidiary. The reorganization forms the basis of establishing the values to be used; the consolidation revisions will concern stock equity accounts. Changes in consolidation excesses attributable to intangibles will run against the parent company's equity only, unless the full value of such intangibles has been imputed to the subsidiary. Other revisions will affect both the parent and the minority. To carry out the usual rule that earned surplus must be

exhausted before charges against capital are permissible, the accountant must consider that all write-downs are offsets against surplus earned since acquisition. Amounts exceeding the retained earnings since acquisition will reduce the parent's contribution and will be reflected as a reduction of parent company earned surplus in the consolidation. The minority must, of course, bear its proportion of the change through its entire earned surplus and its capital, unless the revision is based on the association rather than the parts. Those authorities who treat the minority as a liability sometimes suggest that the majority bear all losses (see Chapter VII), leaving the minority unchanged. On the other hand the minority cannot participate in earnings until such losses are recouped and the minority, as a stockholder, must look to dividends based on earnings for its only reward. Write-downs affecting the minority may well be offset first against the minority interest in the appreciation set up at acquisition and unrealized at the date of the reorganization. Write-ups will be treated as appreciation for both the parent and the minority.

Changes in Percentage of Control

In some respects, changes in the stockholdings in any of the affiliated companies can be considered for the joint portrayal just as similar changes would be considered for a single company. The treatment of the majority and the minority as associated owners leads to the conclusion that changes in their relative positions do not involve material changes in the joint undertakings. The association of the subsidiary with the parent, however, depends upon the superiority of the parent company holdings of the subsidiary stock. Any stock transaction which deprives the parent of control automatically liquidates

the association of companies, reducing the parent to a mere investor. Any transaction that weakens the control of the parent makes consolidated statements more dubious because the parent's participation in the rewards of enterprise are reduced and the parent's control of the direction of the enterprise is jeopardized.

Purchase of Stock from the Minority

The parent may increase its stockholding by acquiring stock from the minority or by acquiring stock directly from the subsidiary company. Whenever the minority has not matched the parent's new holdings proportionally, there will be a shifting of ownership to the parent.

The procedure outlined earlier revalued the subsidiary accounts for consolidated statements on the date control was established. The question arises as to whether this same procedure is justified for each additional purchase. Some revaluation of this order may receive support for substantial additions but revaluation is inadvisable for every new block of ten shares the parent may buy.¹² Yet the price paid for each new purchase of securities must be assumed to represent the cost to the parent of the underlying values. The proportion of a minority equity acquired and a proportion of the parent's excess

¹²"In the event that subsequent transactions in the subsidiary's shares demonstrate a mistake in the original valuation of consolidated goodwill, or a change arising from new conditions, the whole amount should be recalculated and the revised valuation substituted for the earlier. This reappraisal is not in response to fractional shifts in a parent's proportionate holdings but to new evidence more reliable or more up to date than that formerly available." M. Moonitz, The Entity Theory of Consolidated Statements, p. 71, American Accounting Association, monograph no. 4, Chicago, 1944. This statement should be taken in light of Moonitz' advocacy of full imputation of goodwill.

attributable to intangibles can be assigned to a new holding by the parent. Amounts paid in excess of the sum of these two items may have originated by increases in the value of inventoriable assets or intangibles or both. The inconvenience of establishing a new starting point for the values to be included in the consolidation and the unimportance of the new stockholding will make it necessary to record the excess paid as a change in the residue attributed to goodwill and gains or losses on purchase. If the purchase was made to eliminate a nuisance factor, this recourse may be quite accurate. In the normal case, however, there will be an element of error which may be corrected only by a careful amortization of the amount. If the amount paid per share is less than the amount paid for the block that gave control, an adjustment of the excess residue in the other direction would be indicated. The excess may be eliminated entirely if the transaction bears strong evidence that the former purchases were made at a price out of line with value.¹³

The following analysis of the minority position is derived from the revised balance sheet for December 31, 1947, of the Sub Co. shown in the preceding illustration:

Minority capital stock (\$10 par)	\$10,000
Minority earned surplus	4,200
Minority appreciation surplus	<u>2,430</u>
Total minority book value for consolidation purposes	\$16,630
Minority patent cost	<u>2,000</u>
Minority interest in inventoriable items	<u>\$14,630</u>

¹³When there is an increase in degree of ownership an adjustment is usually called for in consolidated goodwill. ... The procedure in this case is identical with that of the determination of the original amount of goodwill provided the additional shares are purchased from minority stockholders. If, however, the increased equity results from

If the parent acquires 200 shares from the minority, there will be a transfer to the "Acquisition Equity" account for consolidation purposes of 20% of \$14,630, or \$2,926. Additions of 200/4,000 of \$6,480 of patent cost and of \$3,680 of consolidated excess, \$324 and \$184 respectively, a total attributable to intangibles of \$508, bringing the total for the new equity to \$3,434, will place the new security on the same per share value basis as the old shares held by the parent. If the parent paid \$5,000 for the 200 shares, a difference of \$1,566 will be added to the consolidation excess. A survey of the current value may indicate that the extra amount is attributable to plant, and amortization of the \$1,566 over 12 years may adjust the cost position with respect to operations. There may be some point to showing this \$1,566 as an adjunct to plant until it is absorbed. A purchase price of \$2,500 would result in a downward adjustment of the consolidation excess by \$934. Assignment of this last amount to an inventoriable asset would result in the reduction of operating costs in the future.

Purchase of Stock from the Subsidiary

A slightly different shift takes place if the parent subscribes to a new issue¹¹⁴ of stock for which the minority fails to subscribe. The subsidiary will acquire additional assets and a new stock equity will be set up while the parent will give up assets and

subscriptions to stock newly-issued by a subsidiary a careful consideration of the situation is required." Paton, Accountants' Handbook, op. cit., p. 1084.

¹¹⁴The analysis should be very little different if the stock issued were treasury stock. The adjustments necessary when such treasury stock has been carried as an asset or deducted from earned surplus is pointed out by Walton and Langer, op. cit., L35-1.

will receive additional securities. The proportion of the equity assignable to the new stock will not correspond to the value reflected on the parent company books without adjustment, for the price paid will be more or less than the book value per share of the minority interest, or at least fail to reflect remainders of intangibles attaching to the minority. An adjustment similar to the one suggested above will need to be made to reconcile subsidiary values with the parent company investment account. Unless an appropriate transfer is made to consolidated earned surplus, this type of transaction is likely to result in a decrease in consolidated earned surplus and an increase in consolidated capital surplus of the same amount, essentially a switch between the two accounts. There is no new capital in the group; there is merely a transfer of resources from one division to the other, except from the standpoint of the minority.¹⁵

Assuming that the parent bought 500 shares from the Sub Co. (see revised balance sheet of preceding illustration) at a price of \$9,000, the accountant will need to consider that the minority has given up part of its interests in the surplus accounts and will receive an interest in paid-in surplus:

	Before Issue	Change	After Issue
Minority capital stock	\$10,000	-	\$10,000
Minority earned surplus (1)	4,200	-\$382	3,818
Minority appreciation surplus (1)	2,430	- 220	2,210
Total for consolidation	<u>\$16,630</u>	<u>-\$602</u>	<u>\$16,028</u>
Minority patents cost	<u>2,000</u>	<u>- 181</u>	<u>1,819</u>
Minority interest in inventoriable items	\$14,630	-\$421	\$14,209
Paid-in surplus (10/55 x \$4,000)		+ 727	727
Net effect	<u>\$14,630</u>	<u>+\$306</u>	<u>\$14,936</u>

(1) These items represent a 20% interest which changes to an 18.18% interest or a percentage change of 9.09%

¹⁵H. W. Goodson illustrates this point in an article, "Surplus at Date of Acquisition," Haskins and Sells Bulletin, XI, 53, Aug., 1928.

The stock equity of the parent would increase by \$306 less than the amount contributed by the parent. For purposes of consolidation, \$306 will need to be added to the intangibles. The parent's holding was 80% but is now 81.82% an increase of 2.26%. An investigation of the intangibles show that 2.26% of the patents equals \$147 and of the consolidation excess equals \$83, a total of \$230. The balance of the \$306, or \$76, cannot be presumed to be a loss nor does it form an adequate basis for revaluing the subsidiary items. In the absence of knowledge as to the specific values to which it relates the amount of \$76 can be assigned to consolidation excess. The treatment above requires that the portion of the minority patent cost attributable to the equity transferred be eliminated in consolidation. The elimination entry prepared for consolidation would thus take the following form:

Capital stock	\$5,000	
Capital surplus	3,273	
Earned surplus	382	
Appreciation surplus	220	
Patents (parent company)	147	
General excess (83 and 76)	159	
Investment in S Co.		\$9,000
Patents (minority)		181

It is noteworthy that a purchase price of \$7,300 or less would have resulted in a net decrease in the minority equity and an increase in the parent equity exceeding the amount of the contribution but such a price would impute a zero value to intangibles. In this case it may be well to examine all values to be sure that there has not been a material change in the status of the subsidiary requiring a general revision.

Sale of Stock to an Outside Interest

For the sake of completeness, it may be well to consider the case of the sale of stock by the parent, although the consolidation

adjustments required are approximately the reverse of the purchase entries mentioned above.¹⁶ There are some interesting problems, however, not met in the purchase cases.

When the parent sells subsidiary stock to outsiders, there is an increase in the minority equity and a decrease in the parent equity. The parent and minority equities are on a comparable consolidation basis in all respects except for intangible values. There is a question as to whether to attribute the former intangible values of the parent to the new minority, to determine a new intangible value from the price paid, or to impute an intangible value for the new minority from the values reflected by the old minority. There is much to be said for the latter course on the score of maintaining the relationships. Of course, if the parent has been in control for some time, the two parties will probably be comparable in all respects. Another different situation exists in the recognition of a gain or loss on the disposal of the stock. Assuming that the securities have been carried on a cost basis or an ultimate realization basis, the gain or loss on the sale of a part of the securities will be the difference between this value and the sales price for purposes of the parent company reports. For consolidation purposes the gain or loss will be the

¹⁶"The effect on consolidated goodwill depends upon the manner in which that amount has been computed. If the full amount of goodwill has been shown in prior consolidated balance sheets, there will be no effect on it as the result of a decrease in parent company ownership. If the conventional method of showing only the goodwill pertaining to the parent company's investment is followed, it will be necessary to reduce consolidated goodwill proportionate to the decrease in parent company equity. The same result can be obtained by recomputing goodwill as though the parent company had always held the lesser amount." Paton, Accountants' Handbook, op. cit., p. 1084.

difference between the consolidation book value of the shares sold and the sales price.¹⁷ If a gain develops which exceeds the amount of surplus since acquisition, there is an outright gain to the consolidation in the nature of a gift or a realized appreciation. Otherwise, a gain to the parent has the same effect as a dividend distribution.¹⁸

The case below serves to illustrate the problems involved in a sale of stock to a minority interest. P Co. acquired 7,500 shares (out of 10,000 shares outstanding) in 1945 at a cost of \$126,000.

S Co.
Revised Balance Sheet
December 31, 1947

Tangible assets (book value)	\$160,000	Liabilities	\$ 10,000
Tangible assets appreciation	40,000	Capital stock	100,000
Consolidation excess	6,000	Earned surplus - at acquisition	20,000
		Earned surplus - after acquisition	30,000
		Unrealized appreciation	40,000
		P Co. equity in excess	6,000
	<u>\$206,000</u>		<u>\$206,000</u>

¹⁷See C. G. Blough, "Treatment of Gain to Parent on Sale of Stock of Subsidiary and 'Loss' to Consolidation," The Journal of Accountancy, LXXXIV, 65-66, July, 1947.

¹⁸"In determining the gain or loss on the sale for the purpose of the consolidated accounts, the basis should be the cost of the subsidiary's stock to the parent company increased by the parent company's share of the subsidiary's earnings since acquisition, as reflected in the consolidated surplus account, or decreased by the losses of the subsidiary as so reflected. In either case allowance would have to be made for any dividends received by the parent from the subsidiary.

"In adjusting the consolidated balance-sheet to reflect the disposition of the subsidiary, any consolidating entries previously made to absorb the difference between the purchase price of the subsidiary and its net assets, such as debits to goodwill or capital surplus, must of course be reversed." W. A. Staub, "Some Difficulties Arising in Consolidated Financial Statements," The Journal of Accountancy, LIII, 26, Jan., 1932.

Transfers have been made from unrealized appreciation to earned surplus - at acquisition for all appraisal differences assigned to operations.

On December 31, 1947, P Co. sold 1,500 shares for \$32,000.

P Co. carried its investment at cost and made the following entry on its books to record the sale:

Cash	\$32,000	
Investment in S Co.		\$25,200
Gain on sale of S Co. stock		6,800

The shift in equities can be seen from the following tabulation of the old and new position of the parent and the equity assigned to the new minority:

	Parent Equity before Sale	New Minority	Parent Equity after Sale
Capital stock	\$ 75,000	\$15,000	\$ 60,000
Earned surplus - at acquisition	15,000	3,000	12,000
Earned surplus - after acquisition	22,500	4,500	18,000
Unrealized appreciation	30,000	6,000	24,000
P Co. equity in consolidation excess	6,000	1,200	4,800
	<u>\$118,500</u>	<u>\$29,700</u>	<u>\$118,800</u>

It may thus be seen that from the group position that there is something to be said for transferring \$2,300 (\$32,000 - \$29,700) from the parent's earned surplus to consolidated capital surplus. There would be some basis for insisting that \$17,000 be treated as paid-in surplus in the consolidated statements rather than establishing earned and appreciation surplus for the new minority interest. If the group is to be interpreted as one compound corporation, it would seem necessary to treat the proceeds of a new issue of stock as a capital contribution. From the group standpoint the issue of the stock might be treated:

Cash	\$32,000
Consol. e. surplus	4,500
Min. capital stock	\$15,000
Min. e. surp at acq.	3,000
Min. e. surp after acq.	4,500
Min. appreciation	6,000
Min. equity in excess	1,200
Consol. cap. surplus	2,300
P Co. earned surplus	4,500

Cash	\$32,000
Consol. e. surp.	4,500
Min. cap. stk.	\$15,000
Consol. cap. surp.	17,000
P Co. earned surp.	4,500

Min. equity in excess	\$1,200
Consol. excess	\$1,200

Consol. cap. surp.	\$1,200
Consol. excess	\$1,200

Sales of stock by a parent company to an outside interest are likely to be infrequent and the capital surplus element will generally be negligible. If this is the case, the first alternative above, modified to show the whole \$6,800 as parent company earned surplus, will be satisfactory. This result will be automatically arrived at through the regular elimination process by offsetting the parent company proportion against the various stock equity accounts of the subsidiary. When important new capital is obtained by selling subsidiary stock, either directly by the subsidiary or indirectly by the parent, the general validity of the second alternative can hardly be questioned. The procedures necessary to reflect this position are awkward since they cannot be recorded in any set of books but must be set up as consolidation adjustments.

Sale of Stock to the Subsidiary

A retirement of stock by the subsidiary by purchase from the parent may give rise to gains or losses for the consolidation but the determination of this gain or loss is a trifle more complicated. If the parent is paid more than the share value carried for consolidation purposes, there will be a gain to the extent that the minority equity

contributed to the excess. There will be a loss in the case of retirement at less than the share value to the extent that the minority participates in the amount of the equity not recovered by the parent. On the parent company books the gain or loss will be computed as the difference between the retirement price and the carrying value of the securities, but for consolidation this gain or loss will be reduced to the amount of the shift between the parent and the minority, with any balance over the carrying value treated in much the same fashion as a dividend distribution.

The gain or loss determination in both cases will vary according to the method used in accounting for the securities. The tracing of the stock sold to the original cost of that block will give a different gain or loss than a first-in-first-out or a last-in-first-out procedure. In many respects an average cost method is more reasonable since the law states that each share shall have the rights of any other share of the same class. All shares of the same type are identical in every respect and there is no problem of obsolescence. Income tax provisions need have no bearing in this case.¹⁹

¹⁹See E. J. B. Lewis, Consolidated Statements, p. 61, N.Y., 1942.

"The use of the pro rata value of the stock sold is necessitated by the fact that shares carrying control frequently sell for unusual amounts. This difference enhances the value of the stock previously purchased and does not constitute a just cost of the specific shares purchased." G. H. Newlove, Consolidated Balance Sheets, p. 106, N.Y., 1926.

"Sales by a controlling company of subsidiary shares are best treated in the ordinary manner: their cost is the average cost; the profit or loss is the difference between selling price and the average cost. On the consolidated statements the effect is a reduction of a portion of the consolidated excess or surplus, if any, and a gain or loss differing from the controlling company's by the amount of the applicable undistributed profit or accumulated loss since the date of acquisition." Kohler, op. cit., p. 69.

If S Co. (in the last example) bought the 1,500 shares from P Co. paying \$29,700, the consolidated equities would be unchanged except that earned surplus applying to the shares would be shifted to the parent company, assuming that each equity account is reduced proportionately:

	Parent Equity before Sale	Retired Parent Equity	Parent Equity after Sale
Capital stock	\$ 75,000	\$15,000	\$ 60,000
Earned surplus - at acquisition	15,000	3,000	12,000
Earned surplus - after acquisition	22,500	4,500	18,000
Unrealized appreciation	30,000	6,000	24,000
P Co. equity in excess	6,000	1,200	4,800
	<u>\$118,500</u>	<u>\$29,700</u>	<u>\$118,800</u>

This can be seen more clearly by showing the computation of an item. Earned surplus at acquisition was \$20,000 and will be reduced by 15% in the retirement leaving \$17,000. Of this \$17,000 the parent's share is now 60,000/85,000 or \$12,000. Since all of these items are eliminated in consolidation except the earned surplus since acquisition, the stock equity of the parent will be changed by the amount of the reduction of this earned surplus but this reduction will be added to the parent company's surplus through a gain on sale of stock.

If more than \$29,700 is paid for the stock, assume \$30,700, there will be a larger increase in the parent company's surplus, \$1,000. The earned surplus since acquisition will be reduced by \$5,500 instead of \$4,500 leaving a balance of \$24,500 of which 60/85 applies to the remaining interest of the parent or \$17,294. The original interest was \$22,500 but the parent received \$5,500 and has a remaining interest of \$17,294, a total of \$22,794. The parent has thus gained \$294 at the expense of the minority interest which now becomes \$7,206 instead of

\$7,500 of earned surplus since acquisition ($25/85 \times 24,500$).

If \$28,700 is paid for the stock, there will be a decrease in the parent's equity in earnings of more than the increase in the parent's surplus. The reduction of \$3,500 instead of \$4,500 will leave \$26,500 in earned surplus since acquisition. The parent's share, $60/85$ of \$26,500 is \$18,706. The total received, \$3,500, plus the amount retained, \$18,706, is \$22,206 as opposed to the original surplus interest of \$22,500, a loss of \$294 to the parent and a gain to the minority.

In these last two variations the change in the parent company's surplus from the retirement of stock will be different from the change in consolidated earned surplus and it would seem necessary to note this effect in the analysis of consolidated earned surplus in connection with the reduction from retirement of stock.

In all three cases the price paid must exceed the total equity of the stock retired including the equity in consolidated excess before there is a gain on retirement to the parent in the group statements. Constructed in this fashion the full amount of the excess remains on the books, assuming that the subsidiary purchases the parent's interest in this excess. This could be refined to correspond to the earlier conclusion that no excess should be attributed to the minority by offsetting \$353 of the consolidation excess against the minority surplus and by transferring \$847 from the parent's acquisition surplus to the parent's equity in the excess. This result will be automatically obtained in consolidation unless adjustments are made as Exhibit I illustrates.

Evidence that the consolidated excess needs revision or that the retirement of the stock means curtailed activities may be taken into

Exhibit I
Consolidating Work Sheet
Before Stock Transaction

	P Co.	S Co.	Elimina- tion	Consolidat- ed Balance Sheet
Investment in S Co.	\$126,000		\$126,000	
Tangible assets (book value)		\$160,000		\$160,000
Tangible assets appreciation		40,000		40,000
Consolidation excess			(6,000)	6,000
	<u>\$126,000</u>	<u>\$200,000</u>	<u>\$120,000</u>	<u>\$206,000</u>
Liabilities				
Capital stock - P Co.	\$126,000			\$ 10,000
Capital stock - S Co. Maj.		75,000	\$ 75,000	126,000
Min.		25,000		25,000M
Earned surplus - acq. Maj.		15,000	15,000	
Min.		5,000		5,000M
Earned surplus - after Maj.		22,500		22,500
Min.		7,500		7,500M
Unrealized appreciation Maj.		30,000	30,000	
Min.		10,000		10,000M
	<u>\$126,000</u>	<u>\$200,000</u>	<u>\$120,000</u>	<u>\$206,000</u>

Consolidating Work Sheet
After Stock Transaction

	P Co.	S Co.	Elimina- tion	Consolidat- ed Balance Sheet
Investment in S Co.	\$100,800		\$100,800	
Tangible assets (book value)	29,700	\$130,300		\$160,000
Tangible assets appreciation		40,000		40,000
Consolidation excess			(5,647)	5,647
	<u>\$130,500</u>	<u>\$170,300</u>	<u>\$ 95,153</u>	<u>\$205,647</u>
Liabilities				
Capital stock - P Co.	\$126,000			\$ 10,000
Earned surplus - P Co.	4,500			126,000
Capital stock - S Co. Maj.		60,000	\$ 60,000	4,500
Min.		25,000		25,000M
Earned surplus - acq. Maj.		11,153	11,153	
Min.		4,647		4,647M
Earned surplus - after Maj.		18,000		18,000
Min.		7,500		7,500M
Unrealized appreciation Maj.		24,000	24,000	
Min.		10,000		10,000M
	<u>\$130,500</u>	<u>\$170,300</u>	<u>\$ 95,153</u>	<u>\$205,647</u>

account by offsetting the excess against the equity in the excess and by reducing the investment account on the parent's books.

Purchase and Sale of Stock by the Minority

Security transactions between the majority and the minority have been investigated in connection with the study of the parent company transactions. A sale by a minority stockholder to a new stockholder would involve no change, for the total minority interest remains unchanged. Purchase of shares by a minority interest from the subsidiary company not accompanied by a proportionate purchase by the parent as well as sale of stock by the minority interest to the subsidiary will affect the relative interests of the majority and the minority.

There will be a gain or loss from the sale of securities to the minority if the minority contributes less or more than its proportionate share to the company. The gain or loss, however, will not be the whole difference but will be that part of the difference not attributable to the minority holding. Moreover, such a gain will be in the paid-in surplus and must be recorded in the consolidated statements as a capital gain, not a realized earning. Any increase in the number of the shares outstanding will result in the thinning of the earned surplus per share. Care must be taken to insure that the proper reflection on consolidated capital surplus is obtained. A highly improbable situation that has some interesting aspects would develop if the minority purchased securities from the subsidiary for less than its proportionate share before there were any earnings since acquisition. The parent, in this case, would be contributing a donation to a minority shareholder from its original investment. Any sale to a minority will reduce the parent company percentage and should be accompanied by a write-down of

the intangible valuations to the lower proportion. This type of revision, although necessary in this case, does not contribute much in the way of clarity to the information portrayed and necessitates a restudy of the amortization schedules outlined to dispose of the items.

There will be a gain or loss arising from the purchase of securities from the minority by the subsidiary if the retirement price is different from the proportionate share of equity set up for consolidation purposes. An excess paid will result in a loss to the parent to the extent of the reduction of the parent company's equity. A gain will result whenever there is an increase in the parent company's equity. This retirement will increase the parent company percentage of control and should theoretically increase the parent company's intangible items. Here again a question would arise if the retirement were accompanied by curtailed activities.

Miscellaneous Stock Transactions

There are several other types of stock transactions which will bring about a shift in equity between the parent and the minority. A common stock dividend on preferred stock which produces a change in the proportion of the common stock held by the parent will give the parent a different interest in the stock equity accounts. For consolidated statements, the resulting gain or loss to the parent must be reported as applying to the parent company stockholders. Again this shift will imply a change in consolidation excess. Or if there is a failure on the part of the parent or the minority to exercise warrants to subscribe to new issues of participating stock at a price different

from consolidation value, there will be a similar shift in stock equity producing a gain or loss to the parent.²⁰ Conversion of bonds into stock having a different consolidation value than the carrying value of the bonds will also cause a shift of equity and a gain or loss, probably a loss unless the bonds were held and converted by the parent.

Effects of Shifting Equities

From the standpoint of the group of companies reported as one enterprise with the parent stockholders and the minority treated as having associated interests, there will be no fundamental change in stock equity unless an additional minority interest is created or a minority interest is retired. Transfer of assets between the parent and the subsidiary produce no change in total values in the combined picture. The principal concern of this section is the analysis of the effects of stock transactions on the divisions of the equities, not the effects upon the total consolidated equity. The same conditions hold for a single company but in that case the accountant is not concerned with the reporting of the effects of stock transactions upon individual stockholders of a single class of stock.

The accompanying illustration shows the combination of the accounts for the preparation of a consolidated balance sheet. As a slight variation the consolidated excess was not included in the subsidiary list, as the procedure outlined would indicate, in order to stress that the amount applies only to the parent company holding; but excesses applying to inventoriable items were taken up before the subsidiary accounts

²⁰H. A. Finney comments on this point, Consolidated Statements for Holding Companies and Subsidiaries, p. 80, N. Y., 1923.

Consolidating Work Sheet

	Parent	Sub- sidiary	Eliminate	Consoli- dated
Subsidiary stock cost	\$35,000		\$35,000	
Other assets	25,000	\$50,000		\$75,000
Consolidation excess			(2,000)	2,000
	<u>\$60,000</u>	<u>\$50,000</u>	<u>\$33,000</u>	<u>\$77,000</u>
Liabilities	\$10,000	\$ 5,000		\$15,000
Parent company stock	42,000			42,000
Sub. stock held by parent		30,000	\$30,000	
Sub. stock held by minority		10,000		10,000M
Parent company surplus	8,000			8,000
Sub. surplus - parent share		3,750	3,000	750
Sub. surplus - minority share		1,250		1,250M
	<u>\$60,000</u>	<u>\$50,000</u>	<u>\$33,000</u>	<u>\$77,000</u>

were inserted in the work sheet. The surplus of the subsidiary at the acquisition date amounted to \$4,000 and the parent company has a 75% holding. Earnings of the subsidiary since acquisition amounted to \$1,000.

The over-all effects of stock transactions may be related to the above situation. A purchase of additional stock by the parent from the subsidiary for \$5,000 would amount to a transfer of \$5,000 from the parent to the subsidiary but the consolidated tangible assets would remain the same, \$75,000. The total consolidated equities would remain the same except for the effect of the change in intangibles, but there may be a shifting of a small portion between the minority and the parent equity. In the same fashion a sale of stock by the parent to the subsidiary will mean a transfer of assets from the subsidiary to the parent but will leave the total consolidated assets the same except for the consolidated excess.

Any sale of subsidiary stock by either the parent or the subsidiary to an organization not having a connection with the affiliated

group through the parent company will amount to a new issue of stock. This new issue will increase the consolidated assets and the consolidated stock equities. A purchase by the parent company (or by the subsidiary) of subsidiary stock from parties not having an interest in the group will amount to a retirement of stock, for the consolidated assets and the stock equities will be reduced.

Variations

Much the same analyses will result whether the minority is considered a liability or an associated proprietor. In the former case, a purchase of stock from the minority would amount to a retirement of a debt and an issue of stock to the minority would amount to the borrowing of funds, but the amounts attributed to the two interests should have the same relationship. Gains or losses in such transactions would have an earned surplus flavor under the debt hypothesis. A gain from a sale to a minority might thus be reported in the revenue section rather than as an adjustment of the consolidated capital surplus.

Compromise procedures that reflect all of the consolidation excesses in one amount will not be materially different from those outlined. There would be no minority appreciation surplus to adjust for transactions between the parent and the minority, but there may be a larger amount of consolidation excess to attribute to the change in interest.

Summary

Reconciliation of the security valuation on the parent company books with the underlying values of the subsidiary is a continuous process. Cost incurred by a subsidiary after acquisition of control by a

parent company represents cost to the parent. Cost attributed to the items on hand at acquisition must be assigned to the use made of the items. Thus until the cost of the acquisition is used up there may be a difference between cost to the consolidation and to the subsidiary, but with a proper tracing of the acquisition cost to use, parent cost and subsidiary cost will eventually harmonize.

The original reconciliation will also be disturbed by revaluations of the security account on the parent company books or by revisions of the subsidiary values assignable to consolidation. In order to consolidate the accounts after such one-sided adjustments it will be necessary to carry the adjusted values to the consolidated statements or to reverse the revaluation entries. For consolidated statement purposes write-downs of values will be offset against surplus accumulated since the acquisition of control and any balance against parent company surplus and the remaining minority equity.

Unless transactions in the stock of a subsidiary since the acquisition of control bring about a change in the size of the minority interest, there will be no change in the over-all picture. Any stock purchase or sale that changes the parent company percentage of control, however, is likely to change the amount of the underlying values attributable to the investment and affect the reconciliation. It is certainly impractical to undertake a complete revision of the values of the subsidiary for each small change in security holdings, but substantial changes may justify such an adjustment. Without complete revaluation of the items, changes in the holdings of the parent may be recorded by treating the difference between the price and the consolidation value

as an adjustment of the consolidation excess, in the case of a new acquisition by the parent, or as a realized gain or loss to the parent, in the case of a reduction in the holdings of the parent. Consistency requires that if consolidation excess is not fully imputed, the amount of consolidation excess shall at all times apply exclusively to the parent company holdings.

CHAPTER V

SUBSIDIARY BONDS AND PREFERRED STOCKS

Consolidation of the accounts of two companies for purposes of joint portrayal seems to be justified when one of the companies holds a majority of the voting stock of the other. Other equity elements may have ownership characteristics - actual or potential voting power and participation in the success or failure of the company. If these other equities are held by the parent, the essential ownership is strengthened; if held by outside investors, the participation and control of the parent is weakened and the advisability of consolidation becomes more doubtful.

Accounting for Subsidiary Bonds

Aside from the special restrictions sometimes included in bond indentures, bondholders of a subsidiary company do not have a voice in the direction of the activities of the company if the interest and retirement provisions are met. Nevertheless, bondholders contribute long-term funds to a business and must rely primarily upon the success of the business to satisfy their investment and interest demands.

Bond Valuation

Reference was made at an earlier point (Chapter III) to the necessity of revaluing the bonds of a subsidiary at the acquisition date. The value in use of the assets is the capitalized earning power of the assets. Since the sum of the market values of the equities is sum of the values of the various segments of the earnings produced by the assets, it is therefore the sum of the asset values. The price of

common stock, when other important equities are outstanding, can thus form only a partial basis for estimating the asset values.

It is obvious that with a given amount of debt in a corporate situation an investor in the common stock will gain a higher return with a low effective rate of interest on the debt than with a high rate. Since securities are sold on an earnings basis primarily, the parent will pay more for the stock of a subsidiary committed to a low-interest debt than for stock subject to a high-interest debt. This condition leads to the conclusion that the debt is re-established at the acquisition date as if the debt were incurred for group purposes at that date. The relationships of the values can easily be demonstrated by assuming that in the following case it is possible to determine independently the value in use of the assets of Subsidiary Co. In this simplified

Subsidiary Co.
Balance Sheet
December 31, 1947

<u>Assets</u>		<u>Equities</u>	
All assets (revalued)	\$500,000	Bonds payable 4%	\$100,000
		Less Discount (per books)	5,000
		Effective debt (per books)	\$ 95,000
		Capital stock and surplus	405,000
	<u>\$500,000</u>		<u>\$500,000</u>

balance sheet all of the assets including the intangibles were revalued to reflect the values at the date specified. The amount of the stock equity represents the amount that would be paid for the stock if the going rate of interest on the type of debt outstanding corresponds to the effective rate per books (assume 4.35% for a 20 year bond life).

If the market rate were 3.65%, the bonds would have a total value of \$105,000, leaving only \$395,000 for the stock equity. Similarly, a market rate of 4.80% would produce a value of \$410,000 for the stock.

The relationship may be stated more realistically by assuming that the earnings position of the company or the general business conditions have improved since the bonds were issued. The total increase in the value of the stock will not be as great with bonds outstanding as it would be if no bonds were outstanding for there will be a smaller amount of revenue to capitalize at the improved rate. To determine the market's valuation of the business earning power at any given date, it will be necessary to consider all changes in equity values.

In a perfect market a parent company would not pay more than \$395,000 for the stock of Subsidiary Co., above, if the market rate of interest were 3.65%, since it could form a new company, issue identical bonds, and be in the same position with a commitment of \$395,000. In such a perfect market, there may be some question as to whether the parent would pay \$395,000 for the stock if the parent itself is able to borrow at a lower rate than 3.65%. It would seem that expansion by acquiring the stock of a subsidiary at a price which confirms a rate of interest on the debt higher than that which the parent would need to pay, rather than expansion of the parent company directly, would mean that the parent acquires something in addition to the values found in the subsidiary as a separate organization or that some means have been found to circumvent the extra interest charges. On the other hand, if the conditions are reversed and the parent is paying a higher rate than the subsidiary, the parent may be anxious to acquire the stock at any price

less than that justified by the parent's rate. Success in this endeavor should not be reflected by increasing a discount or reducing a premium to force the two to correspond but by considering that the group has issued a debt at a lower rate than that of the parent debt.

The call price of the subsidiary debt will have some effect upon the price paid. Rather than sacrifice the difference between the call price and the value indicated in the price offered for the stock, the stockholders of the subsidiary should provide for the calling of the bonds to produce an increase in value of the stock. If pressed the parent would presumably offer a price for the stock based upon the call price of the bonds. Whenever the parent pays a price for the stock based upon the call price, there will be no gain to the group in the calling of the bonds except in the possibilities of interest savings. On the other hand, the group does not stand to lose if the price paid is based upon the call price, for the debt may be retired at the group issue price and new capital resources may be provided based upon the credit position of the group.

This analysis is subject to the objection that different equity structures may produce different total values. If a high rate of interest per books is attributable to an unduly high proportion of debt or some other distress factor, the market price of the debt may be low, and at the same time the stock price may be based upon a high imputed value for the debt. It may be possible for the prospective parent to buy the bonds and the stock at favorable prices, and by recapitalizing or substituting its own capital for that of the subsidiary, it may bring the underlying assets values into the group at less than

their current values in their particular use. The interest of the parent company in the subsidiary as well as the entry of the parent into the market for the bonds will tend to increase the market value of the bonds and limit the possibilities of such a favorable purchase.

In actual situations it is almost impossible to discover the current values of the assets in the use to which they are dedicated. It was suggested earlier that the inventoriable assets and the debt be valued and that the excess purchase price over the difference between these two be attributed to intangibles. Valuation of the bonds in this situation cannot be determined on the basis of the purchase price of the stock but must proceed from the determination of a reasonable rate of return. The best method may be to select a similar but financially sound company in the same industry with comparable debt as a basis for discovering the current market yield rate. It will be a simple matter, once the yield rate has been discovered, to impute a value to the bonds of the subsidiary. At best this valuation will be informative rather than accurate.

Subsidiary Bonds Held by the Parent

Consolidation of the accounts of two related companies treats the assets of a debtor subsidiary company as being available to satisfy the claim of a creditor company. The elimination of the claim and the debt will depend upon the manner in which the parent company acquired the claim. The parent corporation may have acquired the bonds of the subsidiary directly from the subsidiary before or after the parent acquired control of the stock of the subsidiary, or the bonds may have been purchased on the market by the parent before or after the acquisition

of control.

Whenever bonds are issued directly to the parent company after control is acquired the issue price on the subsidiary books will exactly correspond to the purchase price on the books of the parent. With correct accounting the two book values should continue on the same basis throughout the life of the obligation. Elimination in this situation will be quite simply accomplished by canceling the debt against the claim.

There may be some difference in case the parent acquired the bonds before it acquired enough stock to give it control. The price paid for the bonds before acquisition of the stock may not correspond to the imputed value of the bonds which served to determine the purchase price of the stock. If this is believed to be the case, a gain or loss on the original purchase of the bonds may be recognized by the parent to account for the difference between the parent company's book value of the bonds held and the revised valuation of the bonds at the acquisition date.¹

Bonds acquired on the market sometime after the issue date are likely to be acquired at a price different from book value or acquisition date value adjusted to the date of the purchase. Elimination will require that the book value carried by the parent be brought into agreement with the revised valuation of the bonds. This again may mean a gain or loss to the parent company stockholders.²

¹"Any premium or discount at the date of acquisition arising from the difference between the investment cost and the accumulated obligation on the books of the issuer should be combined with the consolidation excess or surplus arising from the subsidiary affected; any differences from acquisitions thereafter should be regarded as current gains or losses." E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 67, March, 1938.

²"What has happened from a consolidated standpoint is that a debt carried at \$195,000 has been canceled by a payment of \$196,000. As

The gain or loss involved in this situation has a rather peculiar nature. The individual companies will continue to account for the bonds on the basis of the book values. If the parent has paid less than the revised valuation, the parent will eventually report the difference as revenue through its periodic assignment of premium or discount. The conventional consolidation procedure will attribute a gain to the parent stockholders on the basis of the current difference between the adjusted book value of the bonds on the parent's records and the subsidiary's valuation. Obviously the two amounts approach the same maturity value. The result is a continually decreasing gain or loss recognition through the life of the bonds.

From the standpoint of the group as a whole, bonds held by the parent indicate a relocation of assets within the group. Bonds issued by the subsidiary to someone outside the group of companies bring new assets into the group and assign an interest in the profits of the group to that outsider. When such bonds are later acquired by the parent company, the group statement will show a decline in the assets available for productive use by the amount of the purchase price. A purchase price different from the adjusted issue price will be equivalent to a retirement of an obligation at a price different from book

in so many other accounting problems the question of evidence makes it very difficult, in any given situation, to determine the specific reasons for the discrepancy between book value and market price. Whatever the reason may be for the difference, however, a decrease of \$1,000 is recorded consolidated net worth has occurred. Consequently, expediency usually dictates an adjustment through consolidated surplus." W. A. Paton, Accountants' Handbook, p. 1096, N. Y., 1943.

value in the case of an individual company.³ It is generally accepted that this situation produces a gain to the extent that the outsider has failed to recover his commitment and accrued interest or a loss to the extent that the outsider has recovered more than his total claim.

The difference in the parent-sub subsidiary situation lies in the attribution of the gain or loss to an equity outside of the company issuing the bonds.⁴ The parent company, if it continues to hold the bonds, will take up the gain or loss on its books as a matter of regular accounting. It seems necessary to attribute the gain or loss to the parent company in order to report the equity of the parent company stockholders in accordance with their legal claim.⁵

This analysis would seem to require a slight modification of the usual consolidation procedure. There is no point to a continued

³"From the standpoint of the affiliated enterprises as a whole the transaction amounts to a retirement (or acquisition for the 'treasury') of a block of bonds at less than recorded value, with a resulting special 'profit' of \$500. In the consolidated balance sheet, accordingly, it is not unreasonable to treat the reconciling figure as an element of surplus, segregated under a special caption where the amount is at all large. ... Another possible line of interpretation ... considers the difference between the cost of the security and the recorded amount of the liability on the subsidiary books as an adjustment, from a going-concern standpoint, of subsidiary assets." W. A. Paton, Advanced Accounting, p. 772, N. Y., 1941.

⁴"If the useful fiction may be employed that the purchaser acts as agent for the issuer the gain is always assignable to the issuer. In any event consolidated capital increases; the allocation to controlling and minority interests is dependent on the assignment of the gain to P or S." M. Moonitz, The Entity Theory of Consolidated Statements, p. 73, American Accounting Association, monograph no. 4, Chicago, 1944.

⁵"In such a case, it would be more conservative, but not obligatory, to include the net credit as a deferred credit in the consolidated balance sheet." H. A. Finney, Principles of Accounting Advanced, p. 252, N. Y., 1946. See also H. A. Finney, Consolidated Statements for Holding Company and Subsidiaries, p. 67, N. Y., 1923, and F. H. Streightoff, Advanced Accounting, p. 456, N. Y., 1932.

reporting of a gain on the bonds held by the parent. The gain or loss occurs at the time of the purchase or the acquisition of control whichever comes later. Comparisons of beginning and ending consolidated surplus balances should not be affected by the discount or premium accumulations or amortizations after the purchase. It will be well to establish the basis at the acquisition date or the purchase date by revising the amount of the equity of the bonds held by the parent, by reporting a special account to reflect the gain or loss in the preliminary adjusted figures, and by basing further reporting on these figures.

Another problem arises when the parent reissues bonds of a subsidiary. The parent company will recognize a gain or loss for the amount of the difference between the carrying value on the books of the parent and the reissue price. The group, however, must consider the reissue as a new issue of bonds. The consolidated statements should show no gain or loss but should show the reissue price as the amount of the liability. This procedure will require a preliminary adjustment of the bonds of the subsidiary to the reissue price and the cancellation of the parent's reported gain or loss against this preliminary revision.

In all of these cases the minority will be unaffected. It may be well, accordingly, to continue to report the original issue price adjusted for amortizations and accumulations on the books of the subsidiary. The minority appreciation account in the consolidated balance sheet may well reflect the first revaluation to establish at least a minimum of harmony among the interests. A purchase and reissue by the parent will not benefit the minority in any respect and the establishment of a new issue price will have little effect upon the relative interests

except that the different price will produce a different interest charge on the consolidated income statement.

Miscellaneous Bond Problems

The special provisions of some bonds which enable the bondholders to exchange their holdings for stock in the subsidiary or to subscribe to stock on a preferred basis have already been mentioned in connection with valuation of bond issues at the acquisition date (Chapter III) and changes in the relative interests (Chapter IV). It seems advisable to value convertible bonds at acquisition date at the bond value or the conversion value whichever is higher. Conversion will require a transfer from the bond liability account to the stock equity accounts. This is true even if the issue to the bondholder is not based upon conversion but upon a special subscription privilege for in any case the bond equity will include any extra value that attaches to the right to subscribe to stock. Other accounts will, of course, be affected but the determination of the amount as indicated will enable the accountant to use the procedure suggested for a new issue of stock to a minority or to the parent by a subsidiary company. It may be possible that the parent had some difficulty in acquiring sufficient stock to control the subsidiary and resorted to the purchase and conversion of bonds as the "cheapest" means of acquiring the necessary shares. There seems to be no question but that the cost of the bonds should be considered the cost of the securities for which the bonds were exchanged unless the parent had held the bonds for some time before conversion. In this last case, accuracy may demand that the bonds be revalued at the exchange date and the revalued amount taken as the cost

of the stock acquired in exchange.

There is an alternative solution to the valuation of the bonds at conversion value at the date of acquisition. Where the conversion value exceeds the value as a bond, the recognition of the extra value in the consolidated statements will tend to decrease the subsequent interest charges, not an entirely unwarranted condition. The alternative solution would proceed by valuing the bonds on the higher basis but record the bond value as a liability and offset the difference against the consolidation excess. This procedure would be based on the thesis that the equity exists only on conversion but that the unfavorable results of conversion were taken into account by the parent in the price it paid for the assets. The conventional procedure which treats the excess over the individual book values as a lump sum intangible has this effect. Under this assumption it would be necessary to increase the excess at the time of conversion and attribute a portion as a decrease of the minority appreciation account. In general this alternative does not seem to correspond to the conditions as well as the one outlined previously. Conversion rights were included originally to sell the bonds at a higher price and reduce the interest charges. Assignment of the extra amount to the bonds will establish the bond equity at the group issue price at the date of acquisition.

Occasionally the parent company will guarantee the interest on the debt of its subsidiary company. The group statements will not reflect the source of the funds used to discharge the interest obligation. If the parent is compelled to pay the interest there will be set up on the parent company books a special claim against the subsidiary

for the amount paid and the subsidiary will report the debt for unpaid interest as a parent company item. The two special accounts will cancel and the group balance sheet will simply show any interest unpaid.

Retirement or refunding of the subsidiary bonds ahead of the maturity date will be handled in the usual fashion unless some of the bonds are held by the parent company. A gain or loss on retirement must be eliminated from the consolidated statements to the extent that it affects a loss or gain to the parent company. The equity of the parent company stockholders must include the effects of any shifts in equity from the minority interest. Thus bonds called at a price exceeding the book value of the parent and the subsidiary will produce a loss on the subsidiary's books and a gain on the parent company's books. The parent will participate in the loss of the subsidiary to the extent of its proportionate interest. The result will be a gain to the parent company to the extent of the minority's interest in the subsidiary. It is difficult to see any reason why this shift in interest should not be reflected, particularly since there is a transference of assets to the parent company or at least an acknowledgment of an increased equity.

If the bonds of one subsidiary are held by another subsidiary, the solution will proceed in the same manner as if the bonds were held by the parent, with some minor exceptions. These exceptions can be summarized very simply. Whenever there is a gain or loss in the purchase, holding, reissue or retirement of the bonds which result in a shift in the relative interests, some part of the shift in interest will be

attributable to the minority of the subsidiary holding the bonds.⁶

Accounting for Subsidiary Preferred Stock

The part of the total value of a business not assignable to the prior claims of the creditors must be assignable to the stock equity. The stock equity itself may be composed of several different types of claims which have varying preferences. It would be very unrealistic to assume that the parent acquired the same percentage of preferred stocks as common stock. In the normal case it is necessary to determine the equity of each of the various classes of stock in order to determine the parent company's interest at the acquisition date and at the date of each statement thereafter.

Valuation of Preferred Stock

Consistency would indicate that preferred stock be valued on the same basis as bonds, at the current value in light of the going rate of return required by the market for a representative firm in the industry. The common stock of the subsidiary will surely be bought and sold on the basis of the commitments made to the preferred stockholders. Thus if non-participating, non-callable preferred stock was issued at such a high dividend rate that it is now quoted at a price substantially above the total book equity of the stock, failure to show the market price may result in showing a large negative value for intangibles. For example, an \$8 preferred of this description which originally sold at \$100 would be selling at \$200 if the going yield rate had changed to 4%.

⁶This situation is discussed by G. J. Nowak, "What to Eliminate in the Preparation of Consolidated Balance Sheets," The Journal of Accountancy, LXXXIV, 39, July, 1947.

The market value could be reflected in the joint balance sheet by setting up a \$100 premium on the preferred or by adjusting the stock account directly.

On the other hand, preferred stock may be in quite a different position from that of bonds. Wherever preferred stocks participate in earnings, the supposition of the parent's purchase price is conditioned not only by a fair price for the use of capital but also by the relative share in earnings of a participating owner. The price of the common stock of a concern subject to considerable fluctuations in earnings will probably not be as unfavorably affected by the existence of a preferred stock claim as by a debt. Also a relatively large percentage of preferred stock to total equities will probably not be looked upon as unfavorably as the same relatively large percentage of debt. Preferred stock may have somewhat the same effect upon the price of common as debt but in the other cases the preferred may have the same effect as additional shares of common stock.

The term preferred stock covers a multitude of variations of the usual stockholders' rights.⁷ Some sort of dividend priority is

⁷"The conditions and limitations embodied in the contract covering the issue of preferred shares may be grouped, roughly, around four central ideas. They are, first, those provisions having to do with the priority of preferred dividends over dividends on common shares; and the various expedients used with the intent of insuring this priority. There are, secondly, those provisions concerned with the redemption of the preferred shares either under prearranged conditions or at the liquidation of the corporation; and closely allied with these conditions of redemption or retirement is the statement of the lien of the preferred stock in case the corporate property is sold under an order of the court or otherwise disposed of. There are, again, those conditions having to do with the protection of the outstanding preferred stock from dilution through the subsequent issue of other securities having a lien on property or on earnings superior or parallel to it. And to insure the strength of those provisions, many preferred stock contracts require the maintenance

usually involved but there may also be some special liquidation provisions and some voting restrictions. In the one extreme, preferred stock very closely resembles a liability, and in the opposite extreme the preferred differs little from common. The assignment of an interest to preferred stock in consolidation must depend upon the contract provisions of the individual case but some general principles may be outlined.

The treatment of equities outlined in Chapter I for the case of the individual company required that all such claims be reported at the amount of the commitment plus the accrued contractual reward. The reward of the contributors to the stock equity does not accrue as an obligation but as an interest or a share which requires action on the part of the board of directors before it may be attributed to a specific part of the stock equity. For purposes of the preparation of consolidated statements, however, it becomes necessary to determine the total interest of each type of stock in order to discover the equity acquired by the parent,⁸ and it is probably well to report these special stock interests separately in the consolidated balance sheet rather than as a part of generalized proprietorship.

As a starting point it is necessary to assume that the subsidiary will be successful since this is a condition of the parent

of current capital or surplus. And lastly, there are those provisions having to do with the participation of the preferred stock in the management of the corporation." A. S. Dewing, Financial Policy of Corporations, p. 142, N. Y., 1941.

⁸"In consolidation, however, an assignment of each company's surplus is made to the several classes of shares as though cumulative dividends in arrears were some day to be declared in full." Moonitz, op. cit., p. 62.

company's purchase. This assumption has two corollaries; the subsidiary will not liquidate and there will be earnings distributed to the common stockholders as dividends. The first of these corollaries indicates that special liquidation privileges have little effect upon the acquisition price.⁹ The second would seem to require an assignment of a special interest in profits to the preferred. Of course, it may be possible that the acquisition was carried out because of its probable effect upon the profits of other members of the group rather than because of an expectation of dividends from the subsidiary, but it is more reasonable to assume that the parent expects some dividends from the subsidiary. From this analysis it would seem that participating

⁹"It is customary to include in the conditions under which preferred stock is issued, the provision that it shall be entitled to receive an amount equal to its own par value - and sometimes an additional premium - out of the property of the corporation ahead of the common stock, in case it is necessary to liquidate the business. If the preferred stock contract contains no provision specifying the manner in which holders shall be treated in case of liquidation, the assumption to be made is that the common and preferred stockholder shall be treated alike. In that case the residual property, after the payment of prior obligations, would be evenly divided among holders of the stocks. Ordinarily, however, it is deemed an advantage for the preferred stock to be fortified with the 'preferred assets' clause, as the belief has become current - unfortunately a belief generally well founded - that the common stock of most corporations has little property behind it in case of the liquidation of the business. This preferential right to the property ahead of that of the common stock has become quite general with all preferred stocks issued since the period of the First World War. Including the so-called Class A stocks, it has been attached to over two-thirds of the outstanding public utility issues and upwards of nine-tenths of all the industrial issues. This contractual priority pertains both to the voluntary liquidations of the corporation and to the distribution of the residual property, following failure of the corporation; and the courts have sometimes given preferred shareholders the preference they would be entitled to on liquidation when their corporation has been merged with another." Dewing, op. cit., p. 153.

preferred should be valued at the amount of the commitment plus participation in the retained earnings and appreciation, but there are still several difficulties.¹⁰

Although liquidation value can have little significance, a contribution of preferred stockholders in excess of liquidation value would not appear to be a part of the preferred stock equity. It does not follow that a contribution of less than liquidation value must be adjusted to the larger sum. On the other hand, a par value can have little significance other than as a possible basis for dividend declarations. It may be reasonable to select the amount contributed or the liquidation value whichever is the lower.¹¹ In any event the total amount assigned to preferred stock should not exceed the total amount needed to call and retire the stock, for the parent would stand to gain by such a retirement if it were able to acquire common stock on the basis of a higher price for preferred.¹²

¹⁰G. H. Newlove points out that participating preferred is like common except that it does not participate in losses which cause a deficit or profits which wipe out a deficit. Consolidated Balance Sheets, p. 153, N. Y., 1926.

¹¹"Inasmuch as preferred stocks have a limited participation in the liquidation of a corporation, the elimination of holdings by a parent company of preferred stocks of subsidiaries follows in a general way along the same lines as the elimination of intercompany bond holdings. The purchase of the preferred stock of a subsidiary by the parent company produces the same result as though the stock had been redeemed by the subsidiary. In such case any premium would be charged to, and (usually) any discount credited to, surplus account." W. A. Staub. "Consolidated Financial Statements," Accountant, LXXXI, 737, Dec. 7, 1929.

¹²"Those in control of a corporation will always redeem a preferred stock where such redemption is in their financial interest. There is no legal or equitable objection to such a charter provision." Zahn v. Transamerican Corp., 63 Fed. (Supp) 243. In the case, the subsidiary called Class A stock at \$80.80, including accumulated dividends, shortly before liquidation. If the stock had not been called it would have received approximately \$240 per share in liquidation. Transamerican Corp. owned almost all of the Class B stock which benefited.

Modifications of Consolidation Procedures

There are two elements in the consolidated balance sheet that will be affected by the existence of preferred stock in the capital structure of the subsidiary. In the procedure outlined earlier, intangibles were attributed to the different interests in the consolidation and reflected the cost aspects of participation in excess earnings. The second element requiring special attention is the assignment of proprietorship to the preferred stock interest.

Dividend provisions which limit the preferred stockholders to a reasonable rate of return on their investment would indicate that preferred stock does not participate in excess earnings and preferred stock has no interest in the intangibles which reflect excess earnings.¹³ In this situation the determination of the costs of intangibles would proceed as before, based upon the relative interest of the parent company in the common stock. A rate of return, even though fixed, which exceeds the normal requirements for the preferred stock investment would indicate a share in excess earnings, but it may be well to confine the capitalization of such earnings to the common stock element.

Preferred stock which participates with common in earnings after both have received a stated amount per share will definitely have an interest in the excess earning capacity of the subsidiary.¹⁴ In this

¹³"Since non-participating preferred stock cannot share in the excess earning power of the subsidiary, its purchaser does not acquire any goodwill with his holding." Newlove, op. cit., p. 144.

¹⁴"Since non-participating stock cannot control excessive earnings, it cannot be allowed any good-will element in its elimination. As participating preferred stock can control excessive earnings, it should be allowed goodwill in its elimination." G. H. Newlove, "Step-by-Step Procedure in Preparing Consolidated Balance Sheets," American Accountant, XIV, 75, Feb., 1929.

case the assignment of the costs of the intangibles must be based upon a percentage of ownership that takes into account the preferred stock participation. For example, a parent company acquires 60,000 shares of common stock in a subsidiary which has 80,000 shares of common stock and 20,000 shares of fully participating preferred stock outstanding. In this case the parent's share of earnings is discovered by comparing the 60,000 with the sum of 80,000 and 20,000, a 60% interest. If the subsidiary had shown \$50,000 as its cost of goodwill, it will be necessary to attribute \$20,000 as the cost of the goodwill of the remaining minority interest. The parent company's "goodwill" or excess will still be discovered by comparing the acquisition cost of the common stock with the revised valuations of the inventoriable assets attributed to the stock held by the parent.

The procedure followed to determine the equity of the parent at the acquisition date will need to be modified slightly when participating preferred is found to be outstanding. As before, the inventoriable assets and the debt will be revalued at the acquisition date and the difference will be the total of the stock equity omitting the effects of intangibles. This sum will be assigned first to the stock accounts with any balance being treated as surplus. If preferred stock is participating, it will be necessary to add to this surplus figure the book values of the intangibles. The assignment of the surplus to preferred stock can proceed on the basis of the preferred stock's rights in earnings. The remaining common stock not owned by the parent will have a proportionate right in the balance of surplus. With the total of the minority interests determined, the remaining balance of surplus

applies to the parent company. It will be necessary to subtract the segment derived from book values of intangibles before the comparison is made with the acquisition cost in order to determine the excess to be reported as the parent company cost of intangibles.

It may be found that there is insufficient surplus to satisfy the cumulative dividend requirements of the preferred stock or that there is surplus assignable to the minority arising from appreciation. In the latter case it will be necessary to separate the appreciation factor in order to report it as a special item. Insufficient surplus to satisfy the preferred must be taken care of by reducing the capital assignment of the common stock interests.¹⁵ It must be remembered that the parent company is buying the stock for earnings and cannot be expected to pay more than the value remaining after the preferred stock is provided for. Otherwise, the satisfaction of the preferred stock dividend requirements would bring about a loss to the parent.¹⁶

¹⁵"The usual procedure is to add the amount of unpaid cumulative dividends to the aggregate interest of outside preferred shareholders appearing on the credit side of the consolidated balance sheet and, where the subsidiary's common stock is fully owned by the parent company, to reflect the accumulating diminution of the equity of the common stock by current charges against consolidated income as the arrears of preferred dividends accrue. If there is a minority common stock interest outstanding, a proportionate share of such arrears of preferred dividends would be chargeable thereagainst until such minority interest is exhausted." R. H. Montgomery, Auditing Theory and Practice, p. 526, N. Y., 1940.

¹⁶"The guiding principle should be to allocate to non-parent-owned participating preferred stock any portion of the subsidiary surplus which it is clear can be distributed only to such stock, either currently or in liquidation, and in the events of there being a contingency of distribution to the participating preferred stock, which cannot yet be expressed in definite amount, an appropriate note should be made on both consolidated balance sheet and income account." Staub, op. cit., p. 735.

The subsequent operations would proceed as before with the exception of preferred stock dividends in excess of earnings and prior allocations. For consolidation purposes the dividend requirements of the preferred must be allocated whether or not there are earnings to cover the requirements or there have been dividend declarations. The validity of consolidated statements depends upon allocating value to the segment of ownership held by the parent company. The possibilities of escaping the accumulated claim of the preferred stockholders should be considered but cannot be assumed ahead of accomplishment.¹⁷

In some cases the parent company guarantees the dividends on the preferred stock of the subsidiary.¹⁸ When such guaranteed dividends are paid by the parent, there will be a claim against the subsidiary for the amount paid.¹⁹ It is rather interesting that the

¹⁷"It has sometimes been argued that if the unpaid preferred dividends are not guaranteed by the parent company, there is no more need to make a charge therefore in the consolidated income statement than to make a provision for unpaid accumulative preferred dividends in the income statement for a single company. This argument overlooks the fact that the charge in the consolidated income statement is not required because of any obligation on the part of the parent company to pay such preferred dividends but because they represent the accrual of a claim ahead of the common stock owned by the parent company and therefore an accruing loss through diminution of the value of its investment in such common stock. This loss must be recognized and allowed for in the consolidated income statement." Montgomery, op. cit., P. 531.

¹⁸"Among industrials a guarantee of payment of the preferred dividends of a subsidiary corporation is sometimes entered into by the parent. This is particularly common if the subsidiary is incorporated in a state different from that of the main corporation. In this manner the credit of the parent corporation can be used to provide capital for a subsidiary without adequate credit of its own. If in the course of business the operation of the subsidiary proves unprofitable, the courts will, almost invariably, hold the parent corporation liable." Dewing, op. cit., p. 138.

¹⁹"Holding companies sometimes guarantee specified dividends or interest on the securities of subsidiaries in the hands of the public. If arrears of dividends so guaranteed have not been paid by the holding

subsidiary will not be legally liable for this amount if its board of directors has not declared the dividends, but the parent should be in a position to enforce its claim. As a preliminary adjustment the amount of the dividend paid by the parent should be set up as an obligation to the parent.²⁰

It will be well to set up in the consolidated income statement the full amount of the current provision for cumulative dividends whether or not declared or paid in any manner.²¹ In this way the consolidated statements will always show the amount of the total of all equities that is free and clear for the parent company stockholders.²²

company, the liability should be taken up on the consolidated balance sheet and the existence of the continuing obligation also be disclosed." Montgomery, op. cit., p. 520.

²⁰"If, as frequently happens, one company guarantees the interest or principal of a related company's bonds, preferred dividends, or short-term notes, the contingent liability of the guarantor is entirely eliminated in a consolidated balance sheet. The liability will only have to be paid once. The fact that in case of default a company other than the one originally obligated will pay the debt is of no consequence for the group as a whole. Consequently, only the liability shown on the books of the one company will be carried into a consolidated balance sheet." W. A. Paton, Accountants' Handbook, op. cit., p. 1097.

²¹"Whenever the earnings are insufficient to cover the cumulative preferred dividend requirement of minority-held shares, the usual practice is to provide in full for such requirements even though dividends may not be currently declared." P. F. Brundage, Contemporary Accounting, Ch. 5, p. 6, N. Y., 1945.

²²W. W. Werntz, "Some Problems as to Parent Co's.," The Journal of Accountancy, LXVII, 340, June, 1939, lists the systems in use of treating cumulative but unpaid dividends.

1. Deduction from consolidated income, irrespective of the amount of earnings and earned surplus of the subsidiary.
2. Deduction in the income statement to the extent earned, the balance appearing in a footnote or sometimes, where earned surplus of subsidiary existed, being added to the minority interest by a direct charge to consolidated earned surplus.
3. Merely a note to consolidated balance sheet along with arrearages on parent company stock.
4. Another possibility not observed but suggested by Werntz would be to deduct on the income statement the amount earned and charge consolidated earned surplus for the balance irrespective of the surplus of the subsidiary.

Subsidiary Preferred Stock Held by Parent

While the parent company will not pay more for the common than the part of total value (including intangible values) remaining after satisfying the claims of the preferred or providing for the retirement of the preferred, it may be possible to buy up the preferred before or after the acquisition of the voting control of common at less than the accumulated claim or the reconstructed value. If the preferred has voting rights, it may be convenient for the parent to hold preferred stock as a control element.

The elimination will proceed as before except that the parent's holding of preferred stock must be offset against the total of the preferred stock equity. There has been some discussion as to whether the difference between the cost of preferred and its allocated value should be reflected as a consolidation excess. The difference might be treated as a gain or loss on the retirement of the stock since a holding of a claim by the parent amounts to a retirement for the group portrayal. This last proposal may give a reasonable result in those cases in which the parent is able to acquire the preferred at less than the accumulated claim, but is not very sound if the preferred stock has voting rights or participates in the earnings. It may be more reasonable to consider the original holdings at the acquisition date as a joint purchase of the ownership rights which justify consolidation. A higher purchase price for common than the one indicated may have been incurred because of the advantageous purchase of preferred. Nevertheless, a large difference between the equity allocated to preferred and the cost of preferred should receive careful

consideration before it is carried to consolidation excess, particularly if it would result in showing a negative intangible valuation.

Somewhat the same problems arise in later purchases of preferred by the parent company. If the preferred votes or participates in earnings, the elimination of the new acquisition should probably follow the pattern outlined for new acquisitions of common. On the other hand, non-participating and non-voting preferred might be treated at purchase like a purchase of a subsidiary bond. In all cases a purchase at an extremely favorable price produces a transference of surplus to the parent company equity. It should be noted that the surplus allocation will be based upon revised values, an increase in ownership of some real validity.

A resale of the preferred stock held by the parent will amount to a new issue of stock by the group if the dividend requirements have been met on the stock. Cumulative unpaid dividends will continue to attach to the shares in the hands of the new owner and must be allocated to the equity of the minority preferred. Also rights in earnings originating from the participating features must be considered. The intangible valuations must be examined to discover the amount included because of the holding of the preferred, and a portion of the original book value of intangibles may need to be restored.

Other Preferred Stock Problems

Retirement of preferred stock may be accomplished by exercising the call provisions or by purchasing preferred on the market. Call will ordinarily require a payment of all accumulated dividends and a premium over par. If the preferred stock called is not held by the parent, the premium paid will be a joint loss to the

parent company holding and the remaining minority. Preferred stock held by the parent and called by the subsidiary at a premium over the consolidated representation will produce a gain to the parent to the extent that the minority bears the loss on retirement. Purchase of preferred on the market by the subsidiary will give the same result if the price paid exceeds the value segregated for the stock in the joint statements. A price less than the value determined will produce a gain on retirement for both the parent stockholders and the remaining minority on the consolidated statements. Any sort of a retirement of preferred held by the parent will amount to a payment to the parent of its contribution and accumulated dividends. Since it is assumed that the parent will carry the stock at cost, the profit or loss recorded on the parent company books will not correspond to the gain or loss attributed to the parent company stockholders on the consolidated statements.

Sometimes preferred stocks may be converted into common at the option of the holders. Conversion will necessitate a transfer from the preferred stock equity to the common stock equity and an adjustment of the intangible valuations. If the transfer is more than the proportion assigned to the common stock, there will be an increase in the equity of the old holders in which the parent will participate, unless the preferred was converted by the parent. Similarly, a less than proportional transfer to the common stock accounts will reduce the equities of the old holders of common.

Voting rights of preferred stockholders will receive no special recognition in the accounts but must be considered as indicated in all

of the above manipulations. Consolidation must be founded upon the majority of the voting power in the hands of a parent company regardless of the type of securities to which the voting power attaches. Often the preferred stock has voting rights only in case of passed cumulative dividends, but the voting power developed in this situation may be enough to destroy the control of the parent.²³ If the shift in control is very temporary, it may be possible to justify a continuation of the consolidated statements; otherwise the loss of control will mean the termination of the parent-subsidary relationship.

Non-cumulative but restricted dividends fit into the above outline with no major changes. Courts seem to hold that dividends accrue to non-cumulative stock if such dividends are covered by earnings even though declaration may be deferred.²⁴ In constructing the preferred stock equity in this case it will be necessary to check back over the dividend and earnings history of the subsidiary to determine the amount

²³Since 1926, the New York Stock Exchange has refused to list non-voting common stock. For several years, the Exchange, without formal announcement, has been extending this policy to preferred stock not possessing the right to at least one vote per share after recurrent defaults of dividends. However, it has been observed that, in most instances in which preferred stock receives only one vote per share, that right has been of small practical effect because of the numerically superior voting power of the common stock. Recently, in considering issues proposed for listing, the Exchange has been exerting its influence to obtain voting rights sufficient to insure the preferred stockholders at least representation on the Board of Directors upon recurring defaults of dividends." New York Stock Exchange, Department of Stock List, "Statement of Listing Requirements as to Preferred Stock Voting Rights," May, 1940.

²⁴"Defendant admits that where non-cumulative preferred stock has not been allotted the full dividend to which it is entitled in any one year and the corporation for that year has earned more than the dividend paid to the preferred stockholders, the preferred stock is entitled to have allotted to it such withheld earnings to the extent of its priority before dividends are paid to common stockholders." *Cintas v. American Car and Foundry*, 24 A. 2nd. 418 (1942).

of earnings attributable to the preferred stock. With the equity determined the variations will follow the same pattern.

Illustration of Bond and Preferred Stock Problems

The Subsidiary Co. presented the following balance sheet on January 1, 1947. At this date the Parent Co. acquired 20% of the bonds, 10% of the preferred stock, and 80% of the common stock at costs of \$13,880, \$10,200, and \$310,000, respectively. Accrued interest on the bonds amounts to \$1,400. It is found that the preferred is preferred as to dividends and the dividends are cumulative. No dividends have been paid or declared for the preceding year.

Subsidiary Co.
Balance Sheet
January 1, 1947

<u>Assets</u>		<u>Equities</u>	
Inventoriable assets (cost net)	\$450,000	Current liabilities	\$ 15,000
Goodwill (cost)	50,000	Bonds Payable (4%)	70,000
		Less discount	(4,600)
		Preferred stock (\$7)	100,000
		Common stock	300,000
		Earned surplus	19,600
	<u>\$500,000</u>		<u>\$500,000</u>

The bonds are callable at 105% of face and the preferred at 110% of par which is \$100. The parent company is able to borrow on a long-term basis at 3.5% but the subsidiary is in a somewhat inferior position with respect to stability of earnings. It is believed that a strong company in the industry should be able to borrow to the extent borrowed by Subsidiary Co. at a rate of 3.8%. On this basis the bonds should be selling on the market for \$71,950 approximately. The preferred stockholders had

paid in the par amount originally and are entitled to par and accumulated dividends upon liquidation. The audited appraised values show:

Subsidiary Co.
Audited Appraised Balance Sheet Data
January 1, 1947

Inventoriable assets (net)	<u>\$570,000</u>
Current liabilities (including bond interest accrued)	\$ 15,000
Bonds payable (4%)	70,000
Bond premium (to raise to a 3.8% basis)	<u>1,950</u>
Total debt	<u>\$ 86,950</u>
Revised total stock equity	\$483,050
Preferred stock including accumulated dividends	<u>107,000</u>
Revised common stock equity excluding intangible values	<u><u>\$376,050</u></u>
Parent Co. interest in common 80%	\$300,840
Minority interest in common	<u>75,210</u>
Total as above	<u><u>\$376,050</u></u>

The revised ownership interests may now be calculated. The minority interest in the net revised values of \$75,210 must be adjusted for 20% of the goodwill cost, or \$10,000, to give a total value of \$85,210. Subtracting the par value contributed of \$60,000, one arrives at \$25,210 for total minority surplus but of this only \$3,920 can be considered earned surplus. The remainder of \$21,290 should be treated as appreciation surplus. The Parent Co. interest must be considered to be the cost of the common, \$310,000, which indicates a value of \$9,160 as the cost of "goodwill".

The figures to be included in the consolidating work sheets may now be prepared.

Inventoriable assets (net)	\$570,000
Minority goodwill	10,000
Parent Co. "goodwill" cost	<u>9,160</u>
Total assets	<u>\$589,160</u>
Current liabilities (minus interest liability to Parent)	\$ 14,720
Bonds payable - outside	56,000
Bond premium - outside	1,560
Parent Co. bond equity (at purchase price)	13,600
Parent Co. accrued bond interest	280
Parent Co. profit on bond purchase (revised value \$14,390)	790
Preferred stock - outside - with accumulated dividends	96,300
Preferred stock (at purchase price)	10,200
Parent Co. gain on preferred stock purchase (revised \$10,700)	500
Minority common stock	60,000
Minority earned surplus	3,920
Minority appreciation surplus	21,290
Parent Co. common equity (at purchase price)	<u>310,000</u>
Total equities	<u>\$589,160</u>

The eliminations on the consolidating work sheet will be accomplished very simply by offsetting the three investment accounts against the two bond accounts segregated and the two stock equity accounts.

The subsequent reporting of the bonds will require detailed comparisons of the interest schedules based on the two different values. Interest is payable Jan 1, and July 1 of each year and the bonds had 20 years to run on January 1, 1947. The accompanying analysis shows the relative values and interest charges for the first four periods.

Bonds Payable and Interest Charges

Date	Book value net	Revised value net	Difference	Interest charges book	Interest charges revised	Differ- ence
1/1/47	\$65,400	\$71,950	\$6,550			
7/1/47	65,472	71,917	6,445	\$1,472	\$1,367	\$105
1/1/48	65,545	71,883	6,338	1,473	1,366	107
7/1/48	65,620	71,849	6,229	1,475	1,366	109
1/1/49	65,696	71,814	6,118	1,476	1,365	111

Each period the amount of the earnings on the books will be understated by the amount of the excess interest charges. The excess will tend to be shown as a reduction of the surplus since acquisition whereas it amounts to a realization of a previous declination. There are two ways of making the allocation between surplus at acquisition and the surplus since acquisition. The surplus may be accumulated in total each period and the original determination of surplus at acquisition may be subtracted to arrive at the surplus since acquisition. The easiest periodic adjustment is a debit to surplus at acquisition and a credit to a bond account for the original difference in values accompanied by a debit to the bond premium for the total difference in interest charges to date and a credit to surplus since acquisition.

In a similar manner it can be demonstrated that the parent company will be taking up in its interest earned account currently an excess amount which will accumulate to the amount of the profit on the bonds purchased. The consolidation elimination would cancel the interest earned against the interest charges leaving a difference attributable to the original gain. It may be convenient in the preliminary adjustments to segregate the equity pertaining to the parent holding and deduct the original gain to be set up as a special account. The difference in the adjusted equity and the parent account will represent excess interest earned as reported by the parent. There will then be a credit to parent surplus for the original gain and a debit to parent surplus for the excess interest.

In both cases the adjustments of interest to correspond to the interest based upon the revised value of the bonds will produce the

corrected retained earnings for the period to be added to the revised beginning balances of surplus.

Dividends on preferred stock that derive from the amounts segregated at acquisition should not be offset against operating earnings in the subsequent consolidated income statement but should be considered as a return of the preferred stock equity set up at the acquisition date. Elimination of preferred dividends from the income statement and treatment of these dividends as a direct surplus deduction will not change the balance sheet accounts but will show a larger amount of current earnings as being available for future distributions on the income statement. It will be necessary to show segregations of current earnings for preferred stock dividends not currently declared but required by the preferred stock contract. The only preferred stock dividend declarations shown as offsets against current earnings will be declarations of current period accumulations.

Summary

Although the inventoriable assets may be determined in a fairly satisfactory manner by means of an audited appraisal, it seems necessary to devote some attention to the problem of the valuation of bonds and preferred stocks in order to construct a reasonable total value of assets and to reflect the correct interest and dividend conditions. Interest bearing debt and non-participating preferred stocks receive a fixed share of earnings. As conditions change the capitalized value of this share will change, reflecting changes in the values of the underlying assets. It seems reasonable to conclude that all such equities should be revalued as of the date control is established as if the

equities were issued at this date under the prevailing value conditions.

Participating preferred stock, however, is similar to common stock. To the extent that such stock is held by outside investors, the recognition of the current value of the preferred would tend to impute intangible values to the minority interest. It is not clear that such imputation is desirable. Treated in the same manner as common, participating preferred will be assigned a proportion of the difference between the total of the inventoriable assets and the reconstructed debt.

Parent company holdings of bonds or non-participating preferred stocks tend to produce a profit or a loss to the parent of the amount of the difference between the price paid and the reconstructed value. It will be necessary to revise the interest revenue of the parent company to correspond to the interest charges properly attributed to the bonds.

In general, the consolidation procedures at acquisition, as well as later, will follow the pattern outlined for the simple case except that the parent may hold interests in all three types of equities. Elimination of each type must depend upon the determination of the full equity of each type to be offset against the cost of each type. Excesses from these comparisons will produce consolidation excess if the equity participates in higher than normal earnings, otherwise it may be that these differences should be construed as gains or losses.

CHAPTER VI

INTERCOMPANY CHARGES IN ASSETS

It very frequently happens that one company in a group of affiliated companies sells properties or services to another company in the group. From the standpoint of the individual reports constructed to reveal the conditions and activities of the companies as separate legal entities, intercompany transactions of this sort will be recorded in the same manner as transactions with unrelated companies.¹ In order to bring out the group position, however, it will be necessary to treat transactions within the group as mere transfers which leave the group unaffected.² When goods or services are sold to a member company and the goods or services are still embodied in properties held by this affiliated company, there is an unrealized profit or loss for the group to the extent that the transfer price differs from the assignable costs.³

¹"It may not be amiss to mention that even in preparing unconsolidated statements the principles underlying consolidated statements should receive recognition so that misleading impressions or conclusions by the reader of the unconsolidated statements may be avoided. For example, in the case of a company which has one or more subsidiaries with or through which it does considerable business, it is important that the principle of excluding from the parent company's income account profits which have not yet been actually realized, because goods are still in the hands of the subsidiaries, be applied." W. A. Staub, "Some Difficulties Arising in Consolidated Financial Statements," The Journal of Accountancy, LIII, 10, Jan., 1932.

²"In general, intercompany items and transactions, if significant in amount, shall be eliminated. If not eliminated, a statement of the reasons and the method of treatment shall be made." Securities and Exchange Commission, Regulation S-X, Rule 4-08, Washington, 1940.

³Litigation is now pending in connection with the Gillette Safety Razor Co., occasioned in part by the fact that this company transferred inventory to subsidiaries at a price yielding a paper profit, and reported such profit as 'earnings'. The subsidiaries of course ultimately showed a loss. The parent company's shares, however, had a brilliant

For certain interests, however, the gains or losses involved appear to be fully realized at the point of the transfer.

Selection of the Markup

The determination of the amount of the intragroup charges to be eliminated from the carrying value of an item to be included in the consolidated balance sheet will depend upon the sales price charged and the cost of the item. The first of these two figures is rather easily discovered in most cases but the second figure has been the subject of considerable dispute. It has been customary to include as the cost of intercompany items only the merchandise cost. In the last few years accountants have considered including applicable selling and administrative costs of the subsidiary as well as the merchandising or production costs.

From an economic standpoint, revenues are earned throughout the productive process but the amount of earnings is always doubtful until the items or services are rendered to some one other than the producer.⁴ To determine the amount of earnings realized, it is necessary to record and

stock market career for a time on the strength of the apparent earnings." A. A. Berle and G. C. Means, The Modern Corporation and Private Property, p. 204, N. Y., 1932.

⁴"If intercompany sales are priced on a strict commercial basis it may be argued that the income arising when goods are transferred to an affiliated company represents a genuine increase in current assets and hence may be interpreted as an element of true income even from the consolidated point of view. Moreover, there is force in the view that income is earned by the entire process of production and that it is therefore reasonable to recognize income in terms of significant stages of production. On the other hand it remains true that intercompany income in the inventory has not been realized by sales to outsiders and that if the corporate lines are ignored intercompany sales assume the character of departmental transfers. At the most such income is earned, rather than realized." W. A. Paton, Advanced Accounting, p. 795, N. Y., 1941.

maintain the items produced at cost and match the cost with the proceeds obtained when the items are disposed of to others. All costs of operating a business are costs of obtaining the proceeds of the operation of the business. Failure to carry the entire cost of an item on hand as an asset will result in assigning too much cost to the current operations.

A first approximation of the cost of such transfers may be made by apportioning the total of all charges between the items on hand and the items disposed of during the period. There is a strong case for allocating a portion of all types of charges to assets in the consolidated situation, since the corporate lines have established the branches in tight compartments, facilitating the tracing of all classes of charges to the items handled all the way through a compartment. Thus items outside of the possession of the original processor may be considered to include all the productive services of that processor, while items within the possession of the original processor are still incomplete, perhaps including little if any general administrative services and no selling services.

Roughly, there are but two main divisions of the operating costs - manufacturing or merchandising and distribution. These two sections include all costs that are directly assignable to the activities designated. There are also certain costs of operations which may not be conveniently assigned to either of these divisions but are of a general administrative character. Nevertheless, these general costs have to do with the two main activities, getting the goods or services ready for sale and selling them. In refining the assignment of cost to

goods acquired from an affiliated corporation, an examination of the functions performed by the subsidiary in handling the goods may indicate that costs should not all be included in a pool to be spread over all of the goods handled.⁵

There may be several difficult problems in the assignment of manufacturing overhead between goods produced for the affiliate and goods produced for others, particularly if the affiliate requires first consideration and outside sales are undertaken to absorb idle capacity. The exact situation will suggest the solution and cost accounting procedures will give a reasonable cost assignment.

A sale to an affiliated company should require very little in the way of promotion or collection.⁶ In many cases selling costs may

⁵"It has been suggested by some accountants that the reserve for intercompany profits in inventories should be determined on the basis of the selling affiliates rate of net profit instead of on its rate of gross profit. This procedure would, of course, result in the establishment of a smaller reserve. The procedure probably would be justified if all expenses varied in exact proportion to the sales; this, however, is not the normal condition. Many expenses are fixed; others vary, but not in direct proportion to the sales; and it is therefore incorrect to assume that the elimination of the intercompany sales would result in a corresponding reduction in the expenses. Neither is it practicable to undertake to allocate expenses between intercompany and outside sales. Under the circumstances, therefore, the expedient and conservative procedure is to compute the reserve for intercompany profit on the basis of the rate of gross profit." H. A. Finney, Principles of Accounting Advanced, p. 276, N. Y., 1946.

⁶"Selling costs are not likely to be quantitatively significant in connection with intercompany transactions. There will be, however, packing and shipping costs involved, if nothing else, and such costs should be included in consolidated inventories as legitimate additions to cost. Under an ideal treatment, in fact, all charges actually incurred from the standpoint of the consolidated entity, and reasonably applicable to the goods on hand in the group as opposed to goods sold to the outside, should be deferred. In other words, the amount to be eliminated as unrealized is the element of net income, not gross markup over assigned production cost." W. A. Paton, Accountants' Handbook, p. 1092, N. Y., 1943.

be assignable entirely to sales to outsiders. If a member company should engage in sales promotion to facilitate sales by the affiliate of the goods purchased from the member company, such costs will not be applicable to the goods held by the affiliate but to the goods sold by the affiliate for consolidated purposes.

Studies of the nature of the administrative costs will be necessary to determine the allocation of this item to the manufacturing or merchandising function and the selling function. If a reasonable assignment can be made, the divided amounts can be applied to goods or services sold to the affiliate as indicated above.

Most of the taxes can be prorated to the goods sold on the basis of the tax assessment if they have not been applied in connection with the costs already outlined. Property taxes will be traced to the service of the property taxed, excise taxes will be applied to the unit taxed, social security and unemployment taxes will be traced to the service of the employees. In a similar manner other taxes can be assigned as effectively as any other cost element.

The assignment of income taxes involves some special problems. If taxes are computed on the consolidated basis, there will be no income tax to assign to items held at the end of the period. Consolidated returns cannot be used in many cases, since they are available only to affiliated companies 95% owned by the parent (directly or indirectly controlled through security ownership), and in any case consolidated returns are not required. When such returns are not used, member companies will be taxed as separate corporations. The markup over cost included in goods held by an affiliated company may thus have been taxed to the

selling company. A convenient and reasonable method of allocation of income tax could generally be developed by apportioning the tax on the basis of revenues unless the company is engaged in various activities of different profitability. A more exact method would require the spread on the basis of the profit to be eliminated related to the total net taxable income. While it is conventional to ignore income tax in this situation, it is not entirely reasonable from the consolidated statement standpoint to assess a tax to a period which does not reflect the revenue taxed. By applying a reasonable proportion of the income tax to the goods or services to be charged to following periods, the tax will be treated as a charge against revenues in the period revenues are reported for the consolidation.

Since the assignment of charges to goods held always results in a decrease in the charges against revenues in one period and an increase in the charges against revenues in a subsequent period, these assignments should consist of costs of obtaining revenue or distributions of the resulting profit. Losses do not fit conveniently into either category, except for certain items of an overhead character. A fire loss, for example, applies to a period in that it occurs in the period but has no affect upon succeeding operations. It is generally undesirable to defer the recognition of a loss once the loss has been determined.

The whole purpose of this analysis has been to remove the rewards of ownership from the statements until the rewards have been demonstrated. Interest charges can be construed as an assignment of earnings to a type of an owner. From the standpoint of the creditors

of the selling company, revenues of the company, as measured by the accounts of the separate corporation, have included the intercompany sales, and the adequacy of the interest coverage can be represented only as interest charges relate to the revenues of the company.

If it is reasonable to assign interest to the revenue to which it looks for coverage, the proportion of the earnings embodied in the goods held by the purchaser will serve as the basis of assigning interest charges to the goods.

The elimination of the intercompany profits will leave the goods held by the purchaser at cost to the consolidated group but not at a cost comparable to the cost of other items acquired. The charges accumulated in the manner described will be the average charges for the period used, whereas other items may well be reported on a first-in-first-out basis, portraying the items on hand at the most recent purchase prices. Where costs have varied materially some adjustment to place the intercompany items on a more recent cost basis may be possible. But there are still other disturbing elements. The location of the markup becomes difficult if the purchaser has processed the goods acquired or if the goods have passed through the hands of several subsidiaries. The purchaser itself may have rendered services to the seller at a profit to assist in the original processing of the goods. Again, if the goods are set up to include all applicable charges, the subsequent income statements of the group are likely to include in cost of goods sold or some other charge such items as administrative expenses and income taxes. It would be well to keep a schedule of the charges which may be used to reassign the cost elements to the proper accounts on the consolidated

income statement at the disposal of the item.

Minority Profits

A sale to a parent at a price exceeding cost results in the reporting of a profit by the subsidiary. This profit has been realized by the subsidiary as a separate corporation whether or not the parent company has utilized the goods or services in its own profit-making activities. From the standpoint of the consolidated group, however, there has been merely a transfer of items from one division of the business to another - not a proper basis for considering a profit realized. From the point of view of the minority, the profits have been realized for the minority position is determined by the legal entity against which its ownership claim runs. There are two currently advocated methods of reporting the minority position with respect to intercompany charges in properties.

For many years there was little questioning of the proposition that only the parent company's share of the intercompany charge should be eliminated. There seem to have been many cases of full elimination but even in such cases the accountants paid tribute to the accepted thesis and commonly left the minority stock equity unchanged.⁷

On the other hand, the current advocacy of the elimination of the minority share against the minority earnings includes no new or startling points ignored in the earlier discussions. From a practical

⁷We may say that we have found in each of the two kinds of cases cited that the method most frequently adopted in general practice is to eliminate all the intercompany profit against the holding company's surplus." "Accounting Questions," The Journal of Accountancy, LV, 233, March, 1933.

standpoint full elimination has the advantage of simplicity wherever there are several subsidiaries involved in the transfers.

There can be no objection to full elimination if the minority is insignificant or if the minority is considered a full partner in the group. Neither of these conditions hold for the analysis undertaken here. The minority is assumed to be significant for all cases in this discussion, and the minority is considered an associated interest in only one aspect of the ownership.

The argument that it does not matter how the minority interest is stated in the consolidated statements since the minority is only concerned with its individual statements cannot be allowed to influence the decision. In the first place, the minority should be interested in the affects of the consolidated position upon the individual company. In the second place, a misstatement of an equity element means that some other element is misstated. All equities should be stated at the amount of the commitment plus the accrued contractual reward.

It has been said that it really does not matter anyway because the profit will be included when the goods are disposed of by the parent. The argument is that profits of a subsidiary are considered to be unrealized because the parent has not disposed of the goods at a price which covers the charges; the profit resulting from the markup has not been objectively determined by a sale to an outsider. As soon as such a sale is made the minority will be given credit in the consolidated statements for its share. What happens if such a sale never takes place? The majority represented by the parent never realized the markup but the minority must be given credit as soon as it becomes obvious that the

intended sale or use can no longer be expected.⁸

It is further argued that the amount of the markup gives rise to a controlled profit.⁹ After all, the entire retained earnings of the subsidiary is controlled profit. The best way to indicate that there is a controlled profit is certainly not to remove it from the statements. A full and fair disclosure of the amount and nature of the restriction is essential. The only display of this item currently proposed is in the offset against the charge not against the profit reflection in the surplus.

There is certainly an objection to leaving the amount of the excess charge pertaining to the minority in the asset account. All inventoriable assets should be stated at harmonious values.¹⁰ The use of two values for an item of this sort would require that all items be reflected on a similar basis and would lead ultimately to the conclusion that the minority is not a part of the group. On the other hand, the statement commonly made that inventories including minority charges defy interpretation assumes that inventory costs are harmonious if

⁸See W. T. Sunley and W. J. Carter, Corporation Accounting, p. 380, N. Y., 1944.

⁹"Outside stockholders are entitled to know what portion of their book equities is represented by a 'controlled' profit; that is, a profit that has not yet been realized through a sale to the public." L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 67, March, 1938.

¹⁰"...a new cost is obtained for every different hypothetical size of the minority interest. Surely the proportion in which shares in capital are distributed has nothing to do with the value to be assigned to inventories. To permit assets to assume different values merely on the basis of differing amounts of minority interest is clearly inconsistent with a rational accounting." M. Moonitz, The Entity Theory of Consolidated Statements, p. 80, American Accounting Association, Chicago, 1944.

confined to cost originating from charges made by outsiders.¹¹ This objection even if it be considered valid can be quite easily met by eliminating the full amount of the excess markup and by setting up an adjunct account properly labeled for the minority share. On the other hand, there is no particular reason why the account should be set up as an adjunct. If the portrayal as an asset is desired, it may well be represented along with the other special items pertaining to the minority mentioned in connection with the treatment of intangibles. An amount originating from markups in inventories, for example, has no significance to the group as a current asset but will not cause distortion if portrayed as a separate element. The income statement results of such a portrayal are at least as good as the elimination against the minority equity. The cost absorbed as expense will be clear of excess markups and the minority charge can be absorbed in displaying the assignment of the net between the parent and the minority. Realizations based on sales by the subsidiary during the current period must be reported as a special minority revenue.

Some accountants have worried about the possibilities of

¹¹"The result is an inventory figure defying interpretation: it is not at cost to the consolidation, nor at cost to the affiliated units, nor at market or any other conventional basis to either. It is number without significance to anyone interested in the consolidated group or in any specified member of the group. It is, in the most invidious connotation of the phrase, a 'mere bookkeeping entry'." Ibid., p. 79.

"If, for example, there is a 60% control over a subsidiary, not 60% of any intercompany profits in inventories should be cast out, but 100%. Without this procedure, confusion of 'costs' remains which does not reflect the unitary position of the combined enterprises." Kohler, op. cit., p. 66.

manipulating the statements by transferring items at exorbitant prices.¹² When the parent company's share of such profits are eliminated, as they always should be, the profits accrue to a minority interest. It seems inadvisable for the parent to doctor the statements by giving the minority a profit.

Confusion regarding the elimination of the minority share of markups probably arises from the assumption often made that the consolidated statements are to be prepared as if the several companies were one, a legitimate assumption for an insignificant minority case. If the several companies were really one all intracompany markups in excess of cost would be eliminated. Where a significant minority exists, the several companies are not one; the consolidated statements are a portrayal of a compound corporation. Conflicting conclusions have come out of the assumptions. Moonitz, for example, deprives the minority of these "unrealized" profits but insists that the minority is not a partner.¹³ The same type of analysis might lead to reducing accrued interest payable if the company had not earned the amount necessary to cover the accrual.

None of the arguments advanced demonstrate that the minority interest in markups should be eliminated. On the other hand, inclusion is a positive action and must be supported with respect to the equity

¹²"This leads us back to the purpose underlying the elimination of intercompany profits in inventory. The purpose is to prevent manipulation of profits through affiliated companies." W. T. Sunley, "Inter-company Profits," The Journal of Accountancy, XXXVI, 313, October, 1923.

¹³Op. cit., Chapter IV.

and the asset elements. The minority rights to a realized profit are beyond question. Any complete portrayal of the minority equity must include the full amount of the minority claim. Sound accounting requires that the facts be reported but the facts should be reported in such a fashion that relationships can be clearly discerned. If the minority interest is to receive an element of profit not included in the majority interest, the two interests will not be reported on a comparable basis. In order to restore comparability, the extra element must be separately displayed either in the equity or the asset phase or both. The debit element is never, strictly speaking, a part of the item from which the markup is eliminated. The minority equity explains the increase in this item held by the parent but the equity of the minority is not otherwise related to the increase. From the minority point of view there is an asset to match the equity, and the asset is not the item from which the charge was eliminated; from the point of view of the combination the asset to support the claim has not yet materialized. The only recourse is the one mentioned above, a minority asset somewhat similar to a minority patent cost or a minority goodwill cost. This asset is not a cost factor, however; it is like a receivable in that it represents the results of a realized productive effort. Ultimately it is converted into a current asset when the combination realizes the markup or abandons all attempts to realize the markup.¹⁴

¹⁴Assuming 'arm's-length' transfers, the logical answer is to eliminate only the majority interest's share of intercompany profits. A sale by a parent to a subsidiary having a minority represents a realized profit to the extent that the profit is paid by the minority. A sale by a subsidiary with a minority to the parent represents an actual cost to

Parent Company Profits

When a parent company sells to a subsidiary at a markup in excess of cost, there are two possible treatments of the markup. The entire excess could be eliminated against the parent company equity, or the portion of the markup about which there can be no uncertainty could be maintained.

Current practice and theory hold to the former thesis, that the whole excess charge should be eliminated against the parent company's equity. The effect of the entire excess is to increase the parent company's earned surplus.¹⁵ If the consolidated statements are to represent intercompany markups as unrealized, the entire amount of the markup is unrealized.¹⁶ The parent company owners pay greater attention to the consolidated reports since such reports are primarily

the majority interest for the profit pertaining to the subsidiary's minority interest. The trouble with the above rule is that transactions between a parent and a subsidiary cannot be assumed to be made at 'arm's-length'. Practically, a parent could by the above rule arbitrarily inflate its profits by forcing a subsidiary to purchase merchandise from the parent at a profit to the parent." G. H. Newlove, from manuscript titled, "Consolidated Statements," ch. 4.

¹⁵"To sum up, we cannot avoid the minority's share of the profit in goods on hand with a related company when the minority holding is in the company which sold the goods. But when the whole of the profit has been taken up by the holding company - in other words, when the minority interest is in the company which bought the goods - the whole of the inter-company profit may logically be eliminated." W. T. Sunley, "Minority Interests in Inter-Company Profits," The Journal of Accountancy, XXXV, 355, May, 1923.

¹⁶"However, as no portion of the profit on a sale from a holding company to a subsidiary must be allotted to a minority interest, there is considerable merit in the suggestion that the entire \$1,000 be eliminated. It may be argued that the holding company does not sell any part of the merchandise to the minority interest and that there cannot be any realization of profit on such a sale until the subsidiary has in turn sold the merchandise to a customer." J. B. Taylor and H. C. Miller, Intermediate Accounting, p. 131, N. Y., 1934.

designed to reveal interrelationships in the parent company's interests.¹⁷ The sale of goods to a subsidiary is just one phase of the productive effort that will be completed when the subsidiary in turn sells its product to some one outside the group. It is believed that the income statement of the combined activities will be more meaningful if the entire productive effort is matched against the proceeds.

On the other hand, while the adherence to a harmonious valuing of inventoriable assets requires that the entire amount of the excess margin be eliminated from the item, it does not require that the realized margin shall be removed from the asset picture. As before there remains the possibility of displaying the excess as a parent company asset similar to excess purchase price of securities.

The parent company equity resulted from but does not relate directly to the markup. There is an indirect relationship to a part of the markup through the parent company interest in the subsidiary, but only to a part. The parent company as a separate legal entity has realized the entire amount. The parent company as an effective owner of the properties of the subsidiary stands to lose a share of the markup in the event that outsiders fail to pay enough to justify the total charges. Thus a \$100 markup in excess of cost in a case in which the parent has an 80% interest in the stock of the subsidiary will be

¹⁷"...unless the parent company were obliged to remove the entire \$10,000 from its surplus by the creation of a reserve, the parent company would be in a position arbitrarily to inflate its profits by forcing the subsidiary to purchase merchandise at such a profit as the parent company might dictate." Finney, op. cit., p. 275. There can be little doubt that such arbitrary charges would be fraudulent and subject to the objections of a minority interest.

realized to the parent to the extent of at least \$20 whether or not the full \$100 is realized in the final sale by the subsidiary. The \$20 has been realized; the remaining \$80 has yet to be confirmed.

Full disclosure of the total equity of the parent would require the showing of the effect of the markup realized upon the equity. The offsetting debit does not relate to an inventorable asset but is in the nature of a receivable to be converted into a current asset when the item which received the original markup is disposed of or abandoned. The income statement of the consolidation will show only the cost assignable to revenues. An offset of the amount of the debit element attributable to items disposed of will reduce the parent company's share of current earnings by the amount realized during the earlier period. It will be necessary to report as a special revenue the amount realized by the parent through sales to subsidiaries during the current period.

Profits in Indirect Ownership Cases

The effective realization of a margin in excess of cost to the minority or the majority applies to all cases. If subsidiary A sells to subsidiary B, the minority of A and perhaps the parent will realize part of the markup regardless of the final outcome. Suppose the parent holds 80% control of both A and B and that A sells goods to B as a price which includes an excess over cost of \$100. There is then \$20 of markup that in the event of an unsuccessful disposal will become a loss to the minority of B rather than a failure to realize by the others. Also there is \$20 of realized gain to the minority of A. The parent stands to gain \$80 through its holdings of A regardless of the outcome and it stands to lose \$80 through its holdings of B in the event that the ultimate proceeds

are insufficient to cover the markup. For the parent the markup is yet to be realized. For the minority of A the markup has been realized.

If the holding of A securities had been 85% and the holding of B, 80% there would still be \$20 of realized markup. In this case, however, \$15 applies to the minority of A and \$5 applies to the parent. If the proceeds of the final sale were insufficient, the parent would gain \$85 through its holdings of A and lose \$80 through its holdings of B, a net gain effectively realized of \$5. A holding of 75% of A and 80% of B will give a different result. The minority of A has realized \$25 and the parent has realized nothing. Unsuccessful disposal will mean a loss of the markup of \$20 to the minority of B and \$5 to the parent.

A different situation again results from the parent holding 80% of A, while A in turn holds 80% of B, making an interest of the parent in B of 64%. A sale by A to B including the same excess margin of \$100 will mean a gain to the minority of A of \$20 and to the parent of \$80. Failure to realize the markup will cause B to report a loss of \$100 of which the minority of B would bear \$20 with the remaining \$80 passing to A and of this the minority of A would bear \$16, the remaining \$64 would be borne by the parent. Thus the parent stands to gain \$16 and the minority of A \$4 in any event, matched by a possible loss to the minority of B of \$20. Had B sold to A, however, the minority of B would realize \$20 immediately but unsuccessful operations would result in a loss of \$4 to the minority of A and \$16 to the parent.

Any case can be solved very simply by considering the minority and the parent gains if the final sale does not cover the markup. The

amounts can then be checked to see that the total amount realized by one interest will be borne by some other interest.

To avoid any possible misinterpretation a further word is needed regarding the relationships of the interests in the realized markups. If an interest has realized a markup and the amount of the excess charge is not recovered in the final sale, some other interest will lose the amount realized. This does not mean that the debit element is an offset in the first instance to the interest that may ultimately suffer. The amount of the loss will not be restricted to the markup but to the total outlay unrecovered. The debit element like most other assets will become a loss if the business fails to recover the amount involved but will not be reported as a loss until such failure is determined.

The Location of the Markup

Any asset except cash can be sold by one affiliated company to another and may thus contain a markup. It will be convenient to consider three types of assets, those to be absorbed in operating charges of the following accounting period, those to be absorbed over a number of accounting periods, and those to continue on the books for several periods without absorption. It should be noted that the markup may have originated in a service charge which became embodied in a property element of the acquiring company.

Typical of the items to be absorbed in the following (or at least an early) accounting period in a lump-sum are inventories of merchandise, materials, and supplies. The costs applying to this type will be accumulated and carried as an asset until the disposal of the item in

a following accounting period. In the period of disposal the charges should be separated out and reported according to their various characteristics in the consolidated income statement.

The second type refers to depreciable items acquired from an affiliated company. The adjusted cost of such items will be spread over their estimated lives. No attempt would ordinarily be made to split the assignment to expense to reflect the various component charges in this case.¹⁸

There are a number of different types of assets that fall in the third category. Land, for example, may remain in the possession of the acquiring company throughout the life of the acquiring company. Securities may be acquired from an affiliate and may be held for a number of periods. In both of these cases the cost assignment would refer almost exclusively to the cost to the original holder. Such a carrying value will obviously be inaccurate in many cases and the point of transfer may be considered as ideal to recognize the changed value relationship. To the extent that there is a value change which the accountant wished to treat as unrealized, the best method of reporting may involve a segregation of the equity aspect in an appreciation surplus. Disposal of these items will call for the reporting of any postponed markups.

Assignment of the charges to consolidated operations must be accompanied by recognition of the effect of the markups in excess of

¹⁸C. G. Blough discusses the question of carrying a depreciation allowance from the selling affiliate to the buying affiliate, "Sale of Fixed Assets by Parent to Subsidiary," The Journal of Accountancy, LXXXIV, 66, July, 1947.

cost. Since the total of the charges assigned to expense will be based on cost, the profit recognized will include, if the proceeds are sufficient as measured by revenues, the original markup in excess of cost. The principal problem will be the assignment of the profit according to its point of origin. It is advisable, whether or not the above recommended treatment of minority realizations is followed, to trace the surplus from the consolidated statements of the beginning of the period to the consolidated statements of the end of the period as well as from the consolidated statements to the individual statements. The procedure should not be limited to the calculation of profit exclusions at the time of the preparation of each set of statements, allowing the individual surpluses carried from the beginning of the period to bring in the amounts not currently excluded. The only problem involved in preparing the minority interest reconciliation will be the tracing of the minority interest in intercompany charges to the consolidated recognition of such charges. The same problem will arise for the parent company interest in markups. It will be well to keep a record of the assignment of these charges with notations of the periods of absorption.

Illustration of Markup Elimination

The accompanying work sheets include the accounts of the parent company and subsidiaries 1 and 2 already corrected for acquisition revaluations. The parent has a stock interest of 80% in subsidiary 1 and 75% interest in subsidiary 2. The securities are carried at cost.

It is assumed that the book values of the subsidiary companies represent current values at the time of acquisition. At the time of

acquisition the surplus of subsidiary 1 stood at \$20,000, of subsidiary 2 at \$8,000. The capital stock accounts stood at \$75,000 and \$72,000 respectively and are unchanged.

In 1942, the parent constructed a building at a cost of \$30,000 which was completed and sold to subsidiary 2 on January 1, 1943, for \$32,000. The building has an expected total life of 25 years. Depreciation is assigned 50% to the goods, 25% to selling, and 25% to administration.

During 1947, subsidiary 1 sold goods to the parent at its regular sales price amounting to \$75,000. Of this transfer \$5,000 remain in the parent company's inventory. No selling cost applies to these sales.

At the end of 1946, the parent company's inventory included \$8,000 of merchandise acquired from subsidiary 1. The \$8,000 consists of: \$5,200 merchandise cost, \$1,400 administrative expense, \$100 income taxes, \$10 interest charges, and \$1,290 of excess markup. Of the last figure 20%, or \$258, was reported as minority markup in the last consolidated balance sheet. The entire \$8,000 was sold by the parent in 1947.

Consolidating Work Sheet
Balance Sheet Items
December 31, 1947

	Parent	Sub. 1	Sub. 2	Elimin- ations	Consolidat- ed Balance Sheet
Inventories	\$ 15,000	\$ 8,000	\$ 7,000	\$ 509(3)	\$ 29,491
Other current assets	40,000	22,000	19,000		81,000
Investment in 1	82,000			82,000(1)	
Investment in 2	62,000			62,000(1)	
Land	25,000	15,000	12,000		52,000
Building	90,000	60,000	32,000	2,000(2)	180,000
Equipment	80,000	70,000	50,000		200,000
Minority goodwill		5,000			5,000
Parent excess costs		6,000	2,000		8,000
Minority markups				(102(3))	102
Parent markups				(400(2))	400
	<u>\$394,000</u>	<u>\$186,000</u>	<u>\$122,000</u>	<u>\$146,007</u>	<u>\$555,993</u>
Allowance for depre- ciation - building	\$ 40,000	\$ 20,000	\$ 6,400	\$ 400(2)	\$ 66,000
Allowance for depre- ciation - equipment	35,000	30,000	15,000		80,000
Liabilities	30,000	10,000	13,600		53,600
Capital Stock - parent	200,000				200,000
Sub. 1 capital stock - minority		15,000			15,000M
Sub. 2 capital stock - minority			18,000		18,000M
Sub. 1 surplus acqui- sition - minority		4,000			4,000M
Sub. 1 surplus since acquisition		25,000		20,000(5)	5,000M
Sub. 2 surplus acqui- sition - minority			2,000		2,000M
Sub. 2 surplus since acquisition			5,000	3,750(5)	1,250M
Sub. 1 equity cost		82,000		82,000(1)	
Sub. 2 equity cost			62,000	62,000(1)	
Parent surplus	89,000			1,200(2)	87,800
Parent's subsidiary surplus				(23,750(5)) 407(3)	23,343
	<u>\$394,000</u>	<u>\$186,000</u>	<u>\$122,000</u>	<u>\$146,007</u>	<u>\$555,993</u>

Consolidating Work Sheet
Income Statement Items
Year Ended December 31, 1947

	Parent	Sub. 1	Sub. 2	Eliminations	Consolidated Income Statement
Merchandise sales	\$350,000	\$150,000	\$100,000	\$ 75,000(3)	\$525,000
Merchandise cost of sales	\$225,000	\$100,000	\$ 70,000	40(2) \$ 73,333(3) 2,800(4)	\$318,827
Selling expense	65,000	15,000	10,000	20(2)	89,980
Administrative expense	30,000	25,000	14,000	(1,400(4) 20(2) 1,000(3)	69,380
Income taxes	7,000	2,250	1,600	150(3) (100(4)	10,800
Total expenses and taxes	\$327,000	\$142,250	\$ 95,600	\$ 75,863	\$488,987
Net income	\$ 23,000	\$ 7,750	\$ 4,400	\$ (863)	\$ 36,013
Interest charges	1,000	250	400	8(3) (10(4)	1,652
Net to stockholders	\$ 22,000	\$ 7,500	\$ 4,000	\$ (861)	\$ 34,361
Markup adjustment (net)				176(6)	-- 176
Surplus January 1	67,000	37,500	9,000	24,292(7)	89,208
Surplus December 31	\$ 89,000	\$ 45,000	\$ 13,000	\$ 23,607	\$123,393

Elimination entries:

- (1) To eliminate the parent company equities in the subsidiaries.
- (2) To reduce building and allowance to a cost basis. The markup results in \$80 per year of depreciation charges of which the parent realized \$20 at the point of sale. The additional \$60 is earned periodically and is included in the consolidated net to stockholders.¹⁹

¹⁹No attempt was made to eliminate the excess depreciation applying to the ending inventories held by subsidiary 2, amounting to \$4 approximately. The effect upon operations would wash out substantially since the

(3) To eliminate the markup in the ending inventory and correct sales. The sales figure of subsidiary 1 includes \$75,000 of goods sold to the parent and the parent had resold \$70,000 of these. Thus the \$75,000 does not refer to a sale to an outsider and the \$70,000 is already included in other charges and markups. For the \$5,000 on hand, \$3,333 was charged to merchandise cost of sales, \$1,000 was charged to administrative expense (assuming that \$15,000 applied to sales to parent), \$150 was charged to income taxes (note that there were no profits on outside sales), and \$8 was charged to interest. The balance of the markup of \$509 must be eliminated from the inventory and \$102 must be set up as the minority realization.

(4) The charges attaching to the beginning inventory, \$8,000, must be spread over the charges applying to this period's sales. Since the parent included the whole \$8,000 in merchandise cost of sales, the amount not properly so classified must be removed.

(5) The parent share of the surplus since acquisition is transferred without adjustment but an adjustment from (3) above is made to the amount after transfer.

(6) Previous markups repeated as income this period amount to \$20 and \$258 and must reduce the net. Markups of this period realized but not included in earnings consist of one item of \$102. The net of these items amounts to \$176.

(7) Individual surplus items January 1 include \$22,000 of surplus at acquisition pertaining to the parent purchase, \$1,260 of building profit to be recognized later (21 x \$60), and \$1,032 of inventory markup unrealized. The surplus figure resulting from these adjustment is the January 1 total of all the surplus items reported on the consolidated balance sheet.

Reconciliation of Consolidated Surplus Items

		Minority	Parent	Consolidated Subsidiary Surplus	Total
January 1 balances	Sub 1	\$ 7,500		\$ 12,968	\$ 20,468
	Sub 2	2,250		750	3,000
	Parent		\$ 65,740		65,740
	Totals	<u>\$ 9,750</u>	<u>\$ 65,740</u>	<u>\$ 13,718</u>	<u>\$ 89,208</u>
Earnings reported	Sub 1	\$ 1,500		\$ 6,000	\$ 7,500
	Sub 2	1,000		3,000	4,000
	Parent		\$ 22,000		22,000
Adjustments					
	Prior markups realized		60	1,032	1,092
	1947 markups unrealized			- 407	- 407
Adjusted earnings		<u>\$ 2,500</u>	<u>\$ 22,060</u>	<u>\$ 9,625</u>	<u>\$ 34,185</u>
Total Surplus December 31		<u>\$ 12,250</u>	<u>\$ 87,800</u>	<u>\$ 23,343</u>	<u>\$123,393</u>

beginning inventory charged to expense this period also includes an excess of depreciation.

No discussion of the above illustration is required. The general statement of the principles preceding the problem covered all the points involved. It should be noted that the inclusion of the realized portions of markups does not complicate the solution appreciably.

Markups at Acquisition of the Subsidiary

The principles and procedures outlined will apply equally well to the treatment of markups included in assets of the parent or the subsidiary at the acquisition date. There will be no income statement accompanying the consolidated balance sheet on this date. Adjustments to eliminate markups in excess of cost cannot be used as correction of the operating results but must be made in the same manner as a loss recognition. The objections to elimination of acquisition date markups were pointed out in Chapter III.²⁰

Losses in Intercompany Transfers

In all cases the procedure calls for the assignment of cost to the items transferred. The difference between the complete cost and the transfer price will often represent an unrealized markup but there may be frequent cases of unrealized markdowns below cost. Unless the transfer has served to recognize a material and persisting change in the market

²⁰"The conventional consolidated balance sheet ignores profits made by one related company prior to date of affiliation even though the assets involved are still on the books of another related company; the reason usually given for this procedure is that such profits are not truly intercompany. This point of view is well taken on strictly legalistic grounds, but if a consolidated income statement and a consolidated surplus statement ... are to be prepared as well as a consolidated balance sheet, such unrealized profits should be eliminated in order that the first period's operations will not be at a disadvantage when compared with those of subsequent periods." G. H. Newlove, from manuscript titled, "Consolidated Statements," ch. 3.

conditions, such deficient markups will require elimination to place the consolidated statements on a cost basis. If there is a minority interest, there will be a realization of the loss borne by the minority or the loss borne by the parent which serves to reduce the value basis to the minority. Such a loss of a selling corporation can only be recouped through an interest in the purchasing company in the event the amount is recovered in the final disposal of the item. The restoration to an interest of a part of a markdown which that interest can have no expectancy of ever recovering would not appear to be a correct reporting of the facts.

Full restoration of the markdown would seem to be necessary to maintain the harmony of costs for consolidated reporting. A realized portion of the loss calculated in a similar manner to a gain need not be returned to the equity account. The indicated solution would involve debiting the asset for the amount of the loss restored and crediting the equity which stands to realize the recovery in the event that the final disposal price is adequate. This procedure will mean an excess restoration, amounting to a gain, to the interest standing to recover. The amount of the credit excess may well be treated like an appreciation.²¹ The effect on the equity will, of course, be reflected

²¹This treatment will adequately reflect the cases in which recovery of the markdown is reasonably assured. An alternative, particularly applicable to a situation in which recovery is doubtful, would be to treat the realized markdown proportion as a total asset contra labeled to apply to the parent or minority only, as the case may be. This account would be similar to "negative goodwill" except that it could apply to the parent or the minority depending upon the direction of the original sale. The amount would be treated as a net income correction at the disposal of the item marked down. This alternative would more nearly parallel the one outlined for excess markups.

through the operating accounts, reducing the charges in the period of the transfer and increasing the charges in the period of the final sale, accompanied by a transfer of the appreciation equivalent.

Summary

Consolidated statements are prepared by combining the accounts of a group of companies, treating the group as one compound corporation. When assets are transferred between members of the group - just as when assets are transferred between divisions of a single company - the carrying value for statement purposes should be unchanged. Adherence to the cost basis of valuation will necessitate adjustment of transfer prices to eliminate markups or markdowns found to apply to assets transferred but still held by a member company. Since the revenue recognition is thus postponed until the time of the final sale or utilization of the item transferred, it will be necessary to defer all cost assignments and other charges which can be considered costs of obtaining the final revenue or distributions of the resulting profits - even income taxes and interest charges.

The adjustment of the asset to eliminate a markup or markdown need not be accompanied by an adjustment of the equity of a party for whom the markup or markdown is determined at the point of the transfer. A minority interest in a subsidiary realizes a gain or loss as the subsidiary sells assets, and subsequent events cannot change the amount or cast doubt upon its validity. Since the price charged by a parent in a sale to a subsidiary becomes cost to the subsidiary, recovery of a markdown or failure to realize a markup in the final sale would affect the parent company interest only to the extent of its proportionate

interest in the subsidiary. Thus it appears reasonable to treat the minority interest proportion of a markup or markdown in such a transfer as realized to the parent company interests at the point of the transfer. A realized gain may be matched by a special-interest asset to be treated as an adjustment of the profit of the special interest at the disposal of the original asset. The realized portion of a loss may be treated as an appreciation factor for that interest which stands to gain from the cost reduction. Fictitious gains or losses will require special treatment.

CHAPTER VII

REVENUE AND SURPLUS

Economic justification of the parent-subsidary relationship depends upon efficiencies arising from joint operations. Although it may be that the relationship exists in cases where there is little or no interrelated activity, one would expect to find most parent-subsidary organizations engaging in various types of mutual assistance. Numerous references have already been made to the balance sheet effects of intercompany transactions, and the modifications necessary to consolidate the operating accounts have been mentioned briefly. Greater attention may now be paid to interrelated operations and the effects of operations upon the balance sheet consolidation. There are three natural divisions of a study of the activities of a business: the activities engaged in to produce a profit, the distribution of the profit or loss resulting from these activities, and the treatment of the profits not distributed. Foreign subsidiaries may also be conveniently treated in this section since the special problems arising in this case have to do with the determination and assignment of profits.

Operations

Most intercompany activities result in a showing of revenues on the books of the company rendering services or transferring properties and cost elements on the books of the company receiving the services or properties. From the consolidated statement viewpoint, the two companies are jointly incurring costs for the purpose of producing revenues for the group through sales of goods or services

outside of the ownership circle. It becomes necessary to trace costs incurred in the originating company together with costs added by other companies in the group to the ultimate revenue production of the company accomplishing the final disposition of the goods or services.

Intercompany Merchandising Activities

When goods are sold by one related company to another, there is a debit to accounts receivable and a credit to sales on the books of the selling company and a debit to some merchandise account and a credit to accounts payable on the books of the buying company. Since no transaction has taken place from the consolidated statement standpoint, the obvious elimination would involve the reversing of both sets of entries. It is convenient to change the elimination to show the sale as offsetting the purchase and the receivable as offsetting the payable, for payments will commonly be made between the time of the transfer and the time of the preparation of the consolidated statements which will change the relationship between the claim and the sale and the debt and the purchase.

If some of the goods transferred remain in the possession of the buying company, the elimination will have the effect of a debit to sales for the total price of all the goods transferred and a credit to merchandise cost of sales for the amount of the goods resold together with a credit to merchandise cost of sales for the original cost of the goods on hand to the selling company and a credit to the inventory account for the markup in excess of cost. It was pointed out that other operating costs which attach to the goods should receive similar treatment (see Chapter VI). The same effect may be obtained by debiting

sales for the original sales price and crediting merchandise cost of sales for the same amount. This will understate the sum of the merchandise cost of sales accounts by the amount of the gross markup in the ending inventory which may be corrected by a credit to inventory and a debit to merchandise cost of sales for this markup. Transfers of a previous period may have resulted in a markup in the beginning inventory which has been charged to merchandise cost of sales in the current period. This must be eliminated by a debit to the overstated surplus element and a credit to merchandise cost of sales. It may be convenient to net the adjustments to merchandise cost of sales for beginning and ending inventories as well as the purchase.

It will be necessary to eliminate purchase discount accounts against sales discount accounts. Thus purchase discounts taken will balance sales discounts taken and purchase discounts lost will balance sales discounts collected. There can be no advantage or disadvantage in paying or failing to pay an account when such payment results in the shifting of funds from one part of an organization to another. On the other hand, there will be some effect upon the relationship of the minority and the majority interests.

Freight paid by the vendor company will be one of the several costs that must be assigned to the goods later resold or held by the purchasing company. It will be necessary to treat such costs as these as merchandising rather than selling costs.

For consolidated statement purposes provisions for bad debts should be based upon sales on account outside of the related companies. Write-offs of subsidiary accounts or special concessions based upon the

financial weakness of the subsidiary have no place in the consolidated statements except as they reveal shifts in the equity to or from the minority.¹ To avoid future complications it will be well to offset sales allowances against purchase allowances in the elimination and refrain from any attempt to re-establish the intercompany debt. A write-off of a subsidiary account against the allowance for bad debt would indicate that the allowance must be revised against the sales bad debt adjustment of the current or a preceding period. Acceptance of the write-off on the part of the subsidiary and the recognition of the revised debt will have been accomplished by a credit to purchase allowances or to a special gain. The elimination is ultimately a debit to the purchase allowance or special gain and a credit to the sales bad debt adjustment which provided the means for the write-off.

There has been some question concerning the advisability of offsetting the sales against the merchandise cost of sales. Daniels points out that the amount of gross revenue will decline as compared to the total of assets employed and will tend to make the consolidated statements less susceptible to comparison with similar enterprises in

¹"The charge for bad debts expense and its corresponding credit to allowance for uncollectibles should be scrutinized carefully for amounts arising from intercompany debts. Any such amounts are excluded from consolidated statements. The reason for the exclusion is simply that the debtor-creditor relationship between affiliates is eliminated in total in a consolidated balance sheet; consequently, a charge for bad debts in an income statement has no meaning for the group viewed as a unit. Whether individual affiliates pay or do not pay intercompany debts has no effect on consolidated income or net worth.

"Although the use of an allowance for uncollectible intercompany accounts is undesirable, when such a provision is found an adjustment is made on the consolidated working papers debiting allowance for uncollectibles and crediting bad debts expense of the creditor company." W. A. Paton, Accountants' Handbook, p. 1113, N. Y. 1943.

the same activities.² There is not much question that comparisons of this sort depend upon similarity of activities of the companies compared. On the other hand, consolidated statements of producing and retailing companies cannot be made comparable to the statements of a producing company selling through a wholesaler. Comparability with a company which has producing and retailing branches will necessarily depend upon the elimination of intercompany transfers from the consolidated income statements. Statements of the individual companies may be more adaptable to comparisons than the consolidated statements of a complicated holding company system.

Much the same analysis will apply to cases in which the purchasing company acquires an asset for use or further processing rather than resale in the same form. The elimination in this instance will run against the sales and sales contra and the net purchase price of the asset as carried by the purchasing company. It was pointed out that this will involve continuing elimination as long as the asset remains in the possession of one of the related companies and tracing of the elimination to the ultimate charging of such costs to operations.

Intercompany Service Activities

It is common for the parent company to own the facilities employed by a subsidiary company. This situation usually involves a rental charge for the subsidiary and a rent revenue for the parent company. The elimination of the rent charge against the rent revenue will leave the depreciation and other property costs as costs of the

²M. B. Daniels, Financial Statements, p. 99, American Accounting Association. monograph no. 2, Chicago, 1939.

revenue produced by the use of the property. Similarly special charges for managerial or personal services may be eliminated against service revenues to leave the salary and other costs entailed in such services as cost assignable to revenues. In many cases the costs of such services are assignable to revenues of several periods. This will necessitate the substitution of the underlying costs for the special service charge. The elimination will become very complex in an intricate holding company system in which a special subsidiary is formed to render managerial or engineering services for many subsidiaries. In many instances, there will be few property items that will escape the effect of intercompany markups. A systematic approach to the elimination problems according to the pattern outlined earlier should not be too burdensome.

It is likely that there will be many intercompany services for which no specific charge is made to the benefiting subsidiary.³ It will be difficult to isolate costs of this sort and in many cases it will be unnecessary to make the effort to discover such amounts if there is assurance that the whole amount applies to current-period operations. Administrative assistance rendered by the parent company during the expansion of a subsidiary, on the other hand, should be capitalized to the extent that the costs of such services can be

³"Special care should be taken to ensure that the inter-company transactions, including the apportionment of administrative and other common expenses between the subsidiary and other companies in the group, should be effected as between independent companies." A. W. Wyon, "Holding and subsidiary companies - accounting principles involved in the treatment of earnings and valuation of holdings," Accountant, LXXXIX, 224, Aug. 5, 1933.

determined. A parent or subsidiary engaged in production may incur advertising costs which are intended to promote the sales of the company which performs the selling function. Such costs are not related generally to the goods produced and transferred during the period but to the goods sold during the period by the merchandising company. Since the company incurring the costs probably charges them to expense in the period incurred, the consolidated statements will carry the costs as represented on the books of the advertising company.

Intercompany Interest

In general, intercompany interest is similar to intercompany rent for the charge originates through the use of the property of one related company by another. Aside from the problems arising where there is a difference in the carrying value of the intercompany debt, the elimination is accomplished by offsetting the interest charges against the interest revenue. In all cases of intercompany service charges the consolidated statements must represent the unified ownership aspects of the operations and must produce data cleared of unrealized revenues. Nevertheless it must not be forgotten that there will be effects upon the minority and majority relationship. Revenues arising from services rendered by a subsidiary are realized as far as the minority interest of the subsidiary is concerned. Thus rent, interest, and other services may receive recognition in the consolidated statements only as to the costs incurred, but the share of the profits assigned to the minority must be determined by considering all of the contractual agreements between the subsidiary and the parent. The interest contract is one of these agreements and will have an effect

upon the distribution of the proceeds of operations.

Exchange of Assets

For purposes of the individual company records an exchange of one asset for another will be recorded by considering the current value of the asset exchanged as the cost of the asset acquired. A change of value since the asset exchanged was acquired will be reflected as a gain or loss on exchange. For consolidated statement purposes an exchange in which one company trades property with an affiliated company leaves the group in the same position after the exchange as before. In this situation there may be no offsetting gains and losses. Both property items may have increased in value resulting in the write-up of both. The gains should be eliminated against the write-ups in order to show the cost for the group. Even if the trade is considered as a justification for a maintained write-up it would not be proper to carry the profits as realized gains. A minimum requirement would be the transfer of the gains to appreciation surplus. Yet from the viewpoint of the minority interest the gains or losses from this source are as nearly realized as they ever are in individual company cases.

Exchanges of assets as well as outright sales between affiliated companies will tend to erase valuation contra and adjunct accounts. It will be necessary not only to restore the original net cost for consolidated statement purposes but also to restore the total original cost and the original valuation account in order to preserve the continuity of the reports. To the extent that amortization of cost is indicated by the balance of the allowance contra, it would seem that the contra should measure the costs absorbed by the consolidated group.

There would thus seem to be some point to carrying the assets owned by a subsidiary at net value at the date of the acquisition of the control of a subsidiary and to continue this basis throughout the use of the property by any member of the group. On the other hand, if the contra account is considered to measure the expiration of the service life of an asset and its remaining usefulness, an attempt to reconstruct the cost basis and the total expiration would be justified in the case of any acquisition. In general the first of these two approaches seems more reasonable.

Different Statement Dates

Accountants have sometimes found it necessary to prepare the statements of some of the subsidiaries a month or two earlier than the statements of the parent company in order to have all of the statements of the group available promptly. Consolidation of the accounts is often a complicated and time consuming process which tends to delay the publication of the statements. If early publication is considered more desirable than accuracy, there may be some point to this procedure.⁴ It seems, however, that any material inaccuracies that result from the use of different dates would cast doubt on the advisability of preparing consolidated statements.⁵ In this one instance

⁴"There seems to be no substantial objection to consolidating for informative purposes two balance-sheets of different dates, when the consolidated picture thus shown is not materially different from what it would probably have been had it been feasible to use the same date for both companies." W. A. Staub, "Some Difficulties Arising in Consolidated Financial Statements," The Journal of Accountancy, LIII, 21, Jan., 1932.

⁵"A further reason which may dictate the exclusion of certain subsidiaries from the consolidation is that their fiscal years do not coincide with the period for which the consolidated statements are made. When the fiscal years of foreign or other subsidiaries forming a minor

there is much to be said for submitting individual statements of identical periods with liberal footnotes to indicate the intercompany relationships and leave to the investors the task of constructing the group statements.

Most authorities agree that consolidated statements prepared from individual statements covering different time intervals are justified only if the time difference is insignificant⁶ and the intercompany transactions are unimportant in the interim or the effects of the transactions since the earlier closings have been used to adjust the reports to the last closing date.⁷ If there were no significant intercompany transactions between the closing dates of the subsidiary and the parent and if there have been no significant changes in the

part of the whole enterprise close one or two months in advance of the fiscal year of the group generally, it is usually feasible to consolidate their statements with those of the rest of the group." R. H. Montgomery, Auditing Theory and Practice, p. 512, N. Y., 1940.

⁶"If the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if all the following conditions exist: (1) Such difference is not more than 93 days; (2) the closing date of the subsidiary is expressly indicated; (3) the necessity for the use of the different closing dates is briefly explained; and (4) any changes in the respective fiscal periods of the registrant and the subsidiary made during the period of report are clearly indicated, together with the manner of treatment." Securities and Exchange Commission, Regulation S-X, Rule 4-02, Washington, D. C., 1940.

⁷"In the case of foreign subsidiaries in particular it is frequently impossible to receive the financial statements as of the date of the consolidated balance sheet in time for inclusion in such balance sheet and it is therefore customary to include the accounts of certain of the subsidiaries, in cases where they are consolidated, as of an earlier date. Care should be taken to see that there have been no unusual transactions in the interim and that shipments and remittances within the consolidated group of companies up to the date of the consolidated balance sheet are taken into consideration. The operations of each company should cover a full fiscal period." American Institute of Accountants, Examination of Financial Statements by Independent Public Accountants, p. 36, N. Y., 1936.

status of the subsidiary in this interval, consolidation of the accounts will offer a useful indication of the joint resources and the total of the activity of the group. If these two conditions do not exist, it will be necessary to adjust the statements of the company with the earlier closing date to include the effects of such changes.⁸ Consider the problems involved in preparing these adjustments in cases involving the transfer of merchandise between the related companies. There are two alternatives: the transfer can be considered not to have taken place or the transferred items can be traced to their position at the last closing date. In the first, it would be necessary to allocate all costs attaching to the transfer and represent them as an asset, misrepresenting the balance sheet position.⁹ The second alternative would involve an investigation of the sales and expenses in the interval to discover the revenue produced and the inventory position at the last closing date, if the purchasing company closed earlier, or an investigation of production or merchandising costs of the selling company if it closed earlier. The first alternative misrepresents the condition and activities of the group while the second involves a reconstruction

⁸"Inclusion of companies with dissimilar fiscal years must be handled carefully and provision made for eliminating or at least reducing the effect of the overlapping of dates. The effect of transactions occurring between the close of a subsidiary's fiscal period and the date of a consolidated statement should be indicated, and handled on a consistent basis from year to year." M. Moonits, The Entity Theory of Consolidated Statements, p. 42, American Accounting Association, monograph no. 4, Chicago, 1944.

⁹"If services have been rendered by one company and recorded by a charge to the current account and by a credit to income, and if the balance sheet of the other company was drawn up before the transaction was recorded, an adjustment should be made debiting surplus and crediting the current account of the company rendering the service." H. A. Finney, Principles of Accounting Advanced, p. 254, N. Y., 1946.

of the earlier statements which would probably be as time consuming as basing the consolidation on the same dates and would tend to produce errors.¹⁰

Other excuses given for using different statement dates, such as the desirability of adopting periods which correspond to activities and the desirability of spreading out the work of the public accountants, can have no real justification if the inaccuracies nullify the usefulness of the statements. It would seem that the better procedure would be to adopt a compromise common fiscal year which would accommodate the auditors and would minimize the period-end work.¹¹

Assignment of Income

It has been pointed out several times in this and preceding chapters that the reconstructed income statement of the subsidiary which excluded the effects of intercompany activities does not represent the earnings position of the minority interest. There is some conflict of opinion as to the propriety of assigning profits to the minority if

¹⁰C. Weitz, "Consolidated Profit and Loss Statements of Fiscal Year Companies for S. E. C. Requirements," The New York Certified Public Accountant, XVII, 39-43, Jan., 1947, outlines a system for treating the operations between the closing dates. The effect of the manipulations is to place both sets of statements on the same date basis completely. Several errors of estimate are involved. The procedure does not reconcile the different dates; it reconstructs the statements.

¹¹"The taxable year of an affiliated group which makes a consolidated income tax return shall be the same as the taxable year of the common parent corporation; and, upon having elected to file consolidated returns, each subsidiary corporation shall, not later than the close of the first consolidated income tax taxable year ending thereafter, adopt an annual accounting period, fiscal year or calendar year as the case may be, in conformity with that of the common parent." Prentice-Hall, 1947 Federal Tax Service, vol. II, Par. 17514, Reg. 104, Sec. 23.14, N. Y., 1947.

the group has not yet realized such profits, but there can be no conflicts about the necessity of assigning costs and revenues of an intercompany nature where there is an assignment of a charge to items no longer in the possession of the group. It will be convenient to treat the minority interest in profits as being determined by the individual company income statement, the legal position, and to adjust the consolidated statements to reflect the special claims of the minority group.

Dividends

Dividends on the stock of a subsidiary company, to the extent that they represent an appropriation of earnings since acquisition, will be reflected by a debit to dividend charges or surplus and a credit to dividends payable on the books of the subsidiary¹² and by a debit to dividends receivable and a credit to dividend revenue on the books of the parent. The elimination will be accomplished for consolidated statement purposes by debiting dividend revenue and crediting dividend charges accompanied by an offsetting of remaining balances of dividends payable and dividends receivable. If the surplus of the parent is to be kept separate from the parent's equity in the subsidiary's surplus, there need be no reassignment of subsidiary surplus for the dividend elimination, for the dividend has placed a portion of the earnings of the subsidiary at the direct disposal of the parent company.¹³

¹²"Where a subsidiary company is being financed by the holding company, it is sometimes the practice for the subsidiary to credit the holding company in current account with the dividends declared by the subsidiary company." Wyon, op. cit., p. 223.

¹³"A similar, but more troublesome, case arose when a parent company received dividends charged by its subsidiary to the reserve for depletion. The parent had included these in current income. Whatever

An accrual method of recording the parent company investment in the subsidiary will require that the dividend be recorded on the parent company books as a debit to dividends receivable and a credit to investment. In this case there has been merely a transfer of a part of the claim to a special asset account and a transfer of a part of the surplus to a special equity account. The consolidation requires no income statement elimination other than a treatment of the dividend charge as a direct surplus deduction without income sheet recognition.

If the dividends of the subsidiary are found to be from earnings prior to the acquisition of control by the parent,¹⁴ the treatment of dividends under the cost method of recording investments will be the same as that of dividends under the accrual method, a reduction of investment valuation and the recognition of a special claim on the parent company books.¹⁵ In general, dividends should be

the arguments as to the necessity of providing for depletion as an operating allowance or as to the legality of paying dividends from earnings without allowance for depletion, yet to the extent that depletion has been charged against earnings it would seem that, to the parent, dividends charged to such a reserve should not be considered earnings. ... In any case the broader problem remains as to whether dividends may be treated as earnings to the parent when no allowance for depletion has been made in determining the subsidiaries' earnings." W. W. Werntz, "Some Problems as to Parent Co's," The Journal of Accountancy, LXVII, 339, June, 1939.

¹⁴"Earned surplus on the consolidated balance sheet arising from subsidiary companies should be confined to undistributed profits earned since the date of acquisition, without regard to the period prior to that date during which an interest less than controlling may have been owned." E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 67, March, 1938.

¹⁵"If paid from surplus earned prior to the date of acquisition, dividends of subsidiaries should be treated as liquidation dividends and credited to a valuation account applicable to the investment; should such dividends exceed the investment cost, the excess should be credited to an 'acquired surplus' account in order to distinguish it from other

considered to be appropriations of the most recent earnings, Thus the investment account will only be affected under the cost method if the dividends have exceeded the earnings since acquisition.¹⁶ A further problem arises, however, if there have been profits and losses since acquisition and if there have been dividends exceeding the net difference since acquisition. In this case it must be assumed that the losses are offsets against the profits since acquisition before the dividends are assigned.¹⁷ It is probably not necessary to treat losses as investment deductions even though the losses would have wiped out earnings since acquisition had such earnings not been appropriated for dividends. The consolidated statements will not vary

sources of earned surplus." Ibid., p. 69.

If the dividend appropriation eliminated all of the surplus earned since acquisition including unrealized markups arising from sales to the parent company, the amount applying to the markups should be construed as a reduction of the parent company investment account. The restoration of the cost value of the investment account would seem justified in this case when the markups are realized even though this procedure would treat the earnings of a following period as the basis for the dividend declaration.

¹⁶"As a guide in determining when dividends are drawn from surplus earned subsequent to acquisition as opposed to purchased surplus the most satisfactory rule assumes that dividend appropriations apply to earnings in order, beginning with the most recent accumulation." W. A. Paton, Advanced Accounting, p. 768, N. Y., 1941.

¹⁷"When subsidiaries have sustained substantial losses since dates of acquisition so that the parent company's investment has been impaired, consideration may be given to writing down the investment on the parent company's books, particularly if the losses are not counterbalanced by undistributed profits of other subsidiaries. Though the investment account be not written down on account of subsidiary company's losses, any subsequent dividends from that subsidiary should be credited to investment account by the parent until the losses subsequent to acquisition have been made up." Montgomery, op. cit., p. 513.

by the method of recording the effects of dividends and losses upon the investment account¹⁸ but a knowledge of the methods employed is essential to the preparation of the entries to eliminate the inter-company effects.

If the dividend declared is in scrip or some other form of debt owed by the subsidiary, the eliminations will follow the same pattern. In this case, however, the subsequent reporting may be complicated by interest on the intercompany claim. There may also be some question as to whether the subsidiary surplus should be restored and the parent company's surplus reduced in the consolidated statements if the dividend payment has been postponed indefinitely in this manner and the debt bears no interest.

Stock dividends declared by a subsidiary should receive no recognition in the parent company accounts under the cost method if the stock is of the same class as that already held by the parent. In this case the cost per share has declined but the same total equity is assignable to the parent. For consolidated statement purposes it will be necessary to restore the amount of the dividend appropriation to the subsidiary's surplus in order to show the proper consolidated earned

¹⁸"The stockholder who buys after profits have been accumulated, on the other hand, pays for the stock equity as it stands at date of purchase, and it seems thoroughly sound to assume that surplus and capital as those elements appear on the corporate books are proportionately represented in the price paid."

.....

"It may also be defended on logical grounds where the dividend is declared and paid shortly after the stock is acquired, as in this event the portion of surplus absorbed by the dividend can be assumed to attach to the cash utilized in making payment - an asset not subject to revaluation in either direction." Paton, Advanced Accounting, op. cit., pp. 766-67.

surplus position¹⁹ unless the earnings appropriated originated prior to acquisition. It may be convenient and realistic to consider appropriations of earnings for stock dividend purposes as applying to the oldest surplus balances first. Stock dividends represent permanent retention of earnings rather than distributions, and it is reasonable to assume that the proceeds of the oldest earnings are more likely to be permanently tied up in the subsidiary's properties.²⁰

Although a stock dividend in stock of a different class from that upon which the dividend was declared will only affect the consolidated statements if there is a shift in the equities between the parent and the minority, it is necessary to consider the effect of such a declaration upon the investment accounts of the parent company. The cost method requires the maintenance of investments at the original acquisition price. Since the cost of the original stock applies to two different classes of stock in this case, some reasonable method of allocating the original cost must be found. It may be assumed that

¹⁹"Here the surplus earned since acquisition appears as an element in the consolidated capital stock account. ... An alternative treatment would be to restore the surplus earned since acquisition to the surplus account in the consolidated report. ... It would be objectionable, on the other hand, in that the distribution of the consolidated stock equity between capital stock and surplus would not conform to the formal conditions of capitalization prevailing after the issue of the dividend stock." Ibid., p. 769.

Finney, op. cit., p. 265, suggests showing the capitalization:

"Surplus

Restricted - surplus earned by subsidiary since acquisition capitalized by stock dividend	\$ 9,000	
Free	<u>13,500</u>	\$22,500"

²⁰"It would be perhaps more reasonable to apply stock dividends - a form of surplus capitalization - to accumulated earnings in the order of origin, on the ground that it is the older surplus which has been invested in the business and which is no longer available for actual distribution." Paton, Advanced Accounting, op. cit., p. 769.

the dollars invested contributed equally to the result obtained, leading to the conclusion that the assignment of cost should be on the basis of the relative proportions of the total equities held.²¹ In other words, the equity of the new stock held to the total equity of both types held times the cost of the original type will produce the cost to be assigned to the new stock. If this assignment is to be useful and to be conveniently eliminated for consolidated statement purposes, the equity proportion should be based upon revised values rather than subsidiary book values.

In the event that the dividends on the preferred stock of a subsidiary are guaranteed by the parent company and the parent company holds some of the preferred stock, dividends paid by the parent to outsiders will be shown as a claim against the subsidiary and an obligation of the subsidiary. The dividends accumulated on the shares held by the parent cannot be considered to have received guaranteed dividends and should not form the basis for the intercompany claim. In view of the legal weaknesses of the claim held by the parent to recover dividends paid, it may be desirable to have the board of

²¹"If dividend stock is received from a subsidiary of a class different from that held by the parent, the most defensible treatment, under the cost method of handling the investment account, is that which spreads the total cost equitably over the two classes of stock held. Under the prevailing income-tax rule, however, a 'stock dividend' constitutes income if it gives the shareholder an interest different from that which his former holding represented.

"However, where a stock dividend is received in shares of a class other than that of the shares already held it may be argued that there should be a transfer from the original investment account (at book value) to a new account to an amount equal to the surplus capitalized by the subsidiary which is represented by the shares received." Paton, Accountants' Handbook, op. cit., pp. 1072 and 1074.

directors of the subsidiary acknowledge the claim by a dividend declaration even if it is necessary to borrow from the parent. In some cases such a confirmation may be impossible because of the insufficiency of legally available surplus. In this last case it is presumably inaccurate for the subsidiary to set up an obligation to the parent in any form and the parent's claim will be contingent upon future earnings. In consolidation the amount of such a payment may be considered as part of the parent company dividends at least for the parent company's proportion of ownership. This is not unreasonable for the accumulated dividends on preferred stock should be considered as reductions of the ownership attributed to common stock whenever earnings of the subsidiary are insufficient to cover the preferred dividend. Payment by the parent makes this same analysis more binding and eliminates the possibility of escaping the dividend requirement.

Surplus and Reserves

Unless the parent company surplus is segregated in the consolidated balance sheet and even if it is segregated, it may be impossible to indicate the surplus properly available for dividends to the various ownership interests. The majority interest in surplus at acquisition disappears in consolidation²² and earnings derived from

²²Hence it may be stated that in the absence of any contrary description or explanation, the surplus account in the consolidated balance sheet is to be assumed to represent a surplus accumulated by the parent company and its subsidiaries since the formation of the former and the acquisition of the capital stocks of the latter. This will mean that in a case where the stock of a subsidiary has not all been acquired at one date, part of the profits of a subsidiary may be included in the consolidated surplus from one date and other parts from other dates." W. A. Staub, "Consolidated Financial Statements," Accountant, LXXXI, 736, Dec. 7, 1929.

unrealized intercompany markups are cancelled at least as to the major part. It may be advisable to treat surplus elements as indications of growth rather than as reservoirs from which future dividends may be appropriated whenever the two concepts are in conflict.

An interesting case involving a reduction of earned surplus without a reduction of total surplus is found whenever the subsidiary issues new stock to an outsider at a price at least equal to the revised value per share. The amount of earned surplus assignable to the parent is reduced but is replaced by an interest in the new paid-in surplus. This switch is likely to cause confusion in the consolidated statements and there is some point to considering the earned surplus and paid-in surplus as parts of consolidated surplus portrayed as one figure. A similar problem exists if the parent purchased the stock contributing capital surplus. In this case there will be a transfer of minority earned surplus to the parent and an assignment of a part of the paid-in surplus to the minority. There is nothing to be gained but simplicity of consolidation in this representation and there can be no great objection to treating the earned surplus as unchanged with the whole amount of the paid-in surplus eliminated in consolidation.

Another problem requiring an adjustment of subsidiary surplus for consolidation purposes is found when a deficit at acquisition existed although profits since acquisition have eliminated the deficit. The consolidated statements must reflect the accumulated earnings rather than the dividend potential.²³ This case requires the showing of the

²³"The existence of a subsidiary with a deficit at date of acquisition illustrates an important point, namely, that the consolidated

earnings since acquisition as consolidated surplus.²⁴ No objection can be made, of course, to indicating clearly the limitations of the item.

When the losses of a subsidiary exceed the profits since acquisition there will be a consolidated deficit even though there is no deficit in the subsidiary. This will tend to show an impairment of the group dividend position which may be considered an exaggeration of the real dividend impairment. On the other hand, it is even more important in consolidated statements to consider profits as recoveries of losses rather than as available for appropriation if the surplus is to be used as a measure of growth.

Losses of a subsidiary company should be shared by the minority in proportion to the holdings. In some cases losses may have originated from excess charges for goods or services received from the parent company, and it may be that the parent company will be willing to absorb such losses rather than jeopardize the position of the

balance sheet cannot safely be used as a substitute for that of the parent company in considering dividend policy. A decrease in the deficit subsequent to acquisition will be reflected in consolidated surplus. ...

"In California, and possibly some other states, dividends may be declared under certain conditions, despite the existence of a deficit, on the basis of the earnings of a given period. Ordinarily, however, Company S could not legally declare a dividend until the deficit was wiped out. It would, therefore, be erroneous to interpret 'consolidated surplus' as equivalent to 'surplus available for dividends.'" Paton, Accountants' Handbook, op. cit., p. 1077.

²⁴Accounting questions section of The Journal of Accountancy entitled, "Earnings and Equity of Subsidiary Companies," LXXX, 311-12, Oct., 1945, presents the opinions of three unnamed authorities in support of this thesis.

subsidiary.²⁵ Continuing losses may entirely eliminate the subsidiary's surplus and impair capital.²⁶ If the losses should be great enough to exceed capital, the question arises as to whether a negative minority interest should be shown. There can be no enforceable claim against the minority in most cases for the amount of this debit balance and the parent may have to make any extra contributions needed to maintain the subsidiary.²⁷ On the other hand, the minority cannot expect any dividends until the full capital has been recovered.²⁸ It will generally be better to present the facts of the relationship, the minority debit, unless there is knowledge that the parent intends to underwrite the minority without expecting to be recompensed.

In consolidation, surplus reserves tend to be eliminated and any balances of reserves uneliminated tend to be returned to unappropriated

²⁵"The absorption ... of a loss or deficit is a policy the adoption of which should be approved by the board of directors of both the controlling company and its subsidiary. This policy, often followed where the intercompany transactions of a subsidiary have not been maintained at arm's length, should be recorded on the books of the controlling company and the subsidiary by entries covering the entire amount of the subsidiary's loss or deficit, or, better, the entire amount of the differences attributable to the failure to preserve an arm's length relationship." Kohler, op. cit., p. 68.

²⁶"My own preference has been to consider that all of the operating losses of partly owned subsidiaries should be absorbed by the parent co. so long as there is no earned surplus on the books of those companies to which they can be charged." P. F. Brundage, "Some Shortcomings in Consolidated Statements," The Journal of Accountancy, L. 288, Oct., 1930.

²⁷"When losses are incurred by a subsidiary company which is not wholly owned, a point may be reached where the accumulated losses of the company exceed its share capital. In such an event it is important to remember that the outside interests cannot be called upon to bear further losses and the whole of these must be borne by the holding company itself unless it has made full provision in respect of its shareholdings and sufficient provisions in respect of its advances and has abandoned the subsidiary or has made arrangements whereby the outside interest provide their share of the losses." Wyon, op. cit., p. 224.

²⁸See G. F. Garnsey, Holding Companies and Their Published Accounts, p. 49, London, 1923.

earned surplus. The results lead to the conclusion that the capital of the parent is substituted at least in part for the capital of the subsidiary. To the extent that the parent's capital is made up of contributions rather than retained earnings, there is little danger that dividends will infringe upon such restrictions or portray an excessive amount of free surplus. Reservations of earnings accumulated since acquisition may require special treatment to avoid the impression that they are freely available, particularly if the reservation is dictated by an agreement with creditors of the subsidiary.²⁹ There is possibly some point to considering parent company earned surplus as restricted if the proceeds of the retained earnings can be considered as invested in the subsidiary company.

Dividends of a subsidiary are not all clear to the recipient company but are subject to income taxes unless the companies report on a consolidated basis. Because of these taxes a dividend paid to the parent will not amount to a mere transfer of resources from one division to another but will result in a net decline after transfer in the resources available to the group. Ownership of the underlying assets and the ability to convert the assets to the uses of the parent will be affected by the tax assessment. Although the amount of the tax will generally be determined at the normal tax rate, there are conditions

²⁹"Item (b) would call for segregation of the consolidated surplus to the same extent as the required segregation of the subsidiary surplus pursuant to the sinking fund requirement. Such segregation, however, ... would be made after showing the consolidated income for the year and would be merely an appropriation thereof to a special account instead of transferring the entire amount of the year's net income to the general or unrestricted surplus." Staub, The Journal of Accountancy, op. cit., p. 20.

which may affect the amount of the tax. Tax rates are always subject to change without notice and a dividend paid to a parent in a year in which the parent experiences a loss will not be subject to a tax unless the dividend exceeds the loss. It must also be considered that some of the retained earnings may become a part of the permanent capital and may never become subject to the tax on dividends. There may be some point to reserving a portion of surplus to reflect the probable tax upon anticipated dividends but there is little point to setting up a definite charge and obligation until the dividends have been declared.³⁰

³⁰Profits of foreign and domestic subsidiaries become available to the parent company for distribution to its stockholders only when they are paid over to the parent company in the form of dividends. The dividends so paid are factors in the determination of federal income taxes (and in some cases of state taxes) payable by the parent company. Foreign dividends may be subject to foreign dividend taxes withheld at source. The question arises whether provision for payment of such taxes - even though assessment may be long deferred - should be made currently by the parent company with respect to profits of any subsidiaries included in the consolidated income statement and accumulated in the earned surplus shown on the consolidated balance sheet. Although this point has been recognized in principle, there has not yet developed a clear consensus of accounting opinion as to specific requirements of good practice. Some accountants recommend that provision be made for the full amount of possible taxes at current rates. Others believe that no provision need be made until actual transfer of the profits occurs and the tax liability accrues, inasmuch as some if not all of the profits may be retained by the subsidiaries for investment in plant or for additional working capital or may be offset by subsequent losses. It is also argued that the rates of tax may be materially changed before the profits are transferred or that the transfer may be made to the parent company in some form of tax-free liquidation.

"Current practice in most instances appears to make no provision in the body of the consolidated statements, but, where the amount of such possible loss is material, to append appropriate footnotes to both the consolidated income statement and balance sheet indicating that provision has not been made for such possible taxes in the statements and showing an estimated maximum amount at current rates." Montgomery, op. cit., p. 524.

The effect of revaluations upon consolidated surplus has already been considered. Revaluations should result in values which are harmonious for the majority and the minority but should be considered unrealized until the activities of the subsidiary can be considered to have utilized the revalued assets. As the revalued cost elements are assigned to operations it will be necessary to transfer a part of the appreciation or declination to the earned surplus account.

Abandonment of a subsidiary after it has suffered losses will occasion the recognition of a loss to the parent of the carrying value of the investment unless there is a partial recovery in liquidation. The consolidated statement prepared after the abandonment may present a surplus picture considerably different from the statement preceding the abandonment, particularly if the write-off affected the parent company's capital accounts. Werntz suggests the use of the quasi-reorganization technique of dating surplus to indicate the effect of the change.³¹

³¹Werntz tells of a parent company and three subsidiaries, two of which were profitable, in which it was proposed to sell the losing subsidiary, charge the loss to the parent earned and capital surplus, and merge the remaining subsidiaries with the parent after all of the surpluses had been appropriated as dividends. "As a result, in lieu of a consolidated statement reflecting the net amount of the earned surplus and operating deficits of the parent company and its subsidiaries, there would appear an individual statement of the former parent reflecting the earnings without offset of the deficits. ... In such a case of significant realignment of both the corporate and business structure, the policy of a new start, that I have elsewhere termed a quasi-reorganization, would seem to me to be the desirable method of reflecting the new conditions. Inherent in such a procedure is of course the taking of a new date for computing

Foreign Subsidiaries

Most of the problems met in consolidating foreign subsidiaries are also found in combining foreign branches.³² Once the statements of a subsidiary are converted into dollars the consolidation can take place in the usual fashion. The problem of how to report a gain or loss on exchange fluctuation is no different except that the gain or loss is even more remote.

There seems to be general agreement as to the conversion rates for most of the items appearing on the statements. The consensus appears to be that:³³

1. Assets representing the proceeds of profit-making activities, such as cash and receivables, should be converted at the rate effective at the balance sheet date. Most authorities advocate converting all current assets at this rate.

2. Assets representing efforts expended for the production of revenues in the future, such as plant and even ideally inventories

surplus at acquisition." op. cit., p. 340.

"A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus will be carried through a readjustment in which some losses have been charged to capital surplus.

"If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest therein should be regarded as capitalized by the readjustment, just as surplus at the date of acquisition is capitalized, so far as the parent is concerned." American Institute of Accountants, "Quasi-reorganization or Corporate Readjustment," Accounting Research Bulletin, no. 3, p. 26.

³²The interesting subject of the accounting procedures involved in effecting conversions from foreign-currency amounts is not, as such, peculiar to a discussion of consolidated accounts, for substantially the same problems are present in the case of a direct foreign branch of a company..." E. A. Kracke, "Consolidated Financial Statements," The Journal of Accountancy, LXVI, 387, Dec., 1938.

³³See D. L. Trouant, Financial Audits, pp. 168-170, N.Y., 1937.

and prepayments, should be converted at the rate applying at the time of acquisition. Contras and other valuation accounts should be based upon the same rate.³⁴

3. Current debt should be valued upon the rate quoted at the balance sheet date.

4. Long-term debt will be value at the rate effective at the time the debt was incurred unless the debt is nearing maturity. Any claim or obligation expressed in terms of dollars will be converted to the dollar amount of the contract.

5. Capital stock and capital surplus accounts will be converted at the rate quoted at the date of issuance.

6. There is some disagreement as to the conversion of surplus. The one extreme would make surplus the sum of the retained earnings disclosed by the converted income statements and the other extreme would convert surplus accounts at the rate applying at the balance sheet date.

7. All revenues and charges will be converted at the average exchange rate for the period except absorptions of previously deferred costs. The items excepted will be converted at the rate effective when the costs were incurred.³⁵

³⁴"Rate of exchange at time of transaction is the theoretically correct basis for assets expressed in costs, including investments in stocks and all intangible property. It is permissible, however, to use rate of exchange at balance sheet date for inventories and current prepayments, due to the impracticability of computing inventories in terms of the rates at date of acquisition and due also to the fact that both items will shortly be converted into cash or receivables." M. B. Daniels, *op. cit.*, p. 104.

³⁵"In the preparation of a consolidated statement of income involving foreign subsidiaries, the average rate of the period is often used for translating the operating accounts into United States dollar amounts, except that depreciation should be based on the equivalent

8. Dividends will be converted at the rate effective at the date of the dividend payment.

The amount needed to bring the balance sheet into balance will be set up as "a reserve for unrealized gains or losses on exchange fluctuations."

Care should be taken to value all assets sent from the United States to the foreign subsidiary at the original dollar amount until disposed of. In the case of inventories this method may be difficult but valuation on the basis of the current conversion rate based on the original converted value may produce a gain or loss on exchange fluctuation which has no basis in fact.³⁶

It has been noted that, if the cost of the foreign currency in terms of dollars has increased materially since depreciable properties were acquired by the subsidiary, the conversion of depreciation costs at the acquisition rate will increase the profit reported on the converted income statement to a value higher than the profit converted at the

dollar cost of the depreciable assets. This procedure is generally acceptable in normal times or for converting the accounts of foreign subsidiaries which are operated as branches or which have extensive transactions with affiliates in the United States, but it is open to question whether it always provides a fair determination of the amount of net income which properly should be included in the consolidated income account. The determination of the dollar equivalent of earnings of foreign subsidiaries at the time those earnings arose may not be nearly so important as how much they are going to yield in the form of dividends to the parent. If the foreign subsidiary is a complete manufacturing unit, whose business originates principally in the foreign country, the use of the average rate has no apparent advantages over the exchange rate at the end of the accounting period." Montgomery, op. cit., p. 529.

³⁶See T. B. Robson, "The Construction of Consolidated Accounts - Some Points to be Taken into Consideration," Accountant, XCIV, 366, Mar. 7, 1936.

current rate. This condition should probably not be considered strange or objectionable, for it must be remembered that engaging in foreign operations in any manner necessarily involves speculation in the foreign currency. In this case the proceeds of operations measured in terms of dollars reveals that there is a recovery of the costs involved which exceeds the amount to be expected in the ordinary course of business but there is still a matching of the costs incurred with the proceeds received. Of course, the fact that the dollar may have declined rather than that the foreign currency had increased in value would cast doubt upon the real value of the gain, but this objection has no more validity in this case than in any situation involving a change in the purchasing power of money.

If the retained earnings as represented by the surplus balance is reported by adding the converted profit figures, based upon the average rates for the periods involved applied to revenues and current costs and upon the original rate for cost amortizations, and deducting dividends at the rate effective at the payment date, the surplus balance in terms of dollars may be more than the total value of the surplus legally available for dividends converted at the current rate. In this case a liquidation of the subsidiary at book values (the acquisition value in the case of cost elements) would produce the higher converted surplus value when the proceeds were converted into dollars and remitted to the United States. The question in this case is not the validity of the higher surplus value but the validity of showing surplus in the consolidated balance sheet at more than the amount legally available for dividends if continued operation is assumed.

Since the primary purpose of the consolidated statements is to show the group position as if the properties of the subsidiary were at the disposal of the parent company legally as well as in fact, the underlying value should be considered more important than the dividend potential. Trouant says:

It should be borne in mind that while a surplus balance computed by adding net profits and deducting dividends ... may best represent the results of operations, the amounts which could be currently realized in dividends by the domestic companies are limited to the foreign surplus balances converted at current rates.³⁷

It is exactly this matter of the best representation of the results of operations which should be considered in determining the basis of preparing consolidated statements.

The placing of a value on surplus which exceeds the amount which could be distributed in dividends indicates that the stockholder, in this case the parent company, is committed to a larger investment in the subsidiary in terms of dollars in order to maintain the same scale of operations and that this larger investment is derived from retained earnings. Consistency would demand that those who advocate the conversion of the surplus balance at the current rate should follow through their conclusion and place all expenses on a replacement cost basis. A possible compromise in which the extra amount of surplus is segregated in an account appropriately titled might be generally satisfactory.

The opposite case in which the cost of foreign currency declines after plant and other assets are acquired would state surplus

³⁷Op. cit., p. 170.

in terms of dollars at a lower amount than the legally available surplus converted at the current exchange rate. Liquidation and transmission of funds in this instance would produce an exchange loss. Portrayal of the converted legally available surplus in the consolidated balance sheet would in effect represent capital as surplus, for the realization of this amount in dividends would reduce the capital invested in the subsidiary in terms of dollars.

It is a basic assumption of consolidation that realization of profits by a subsidiary constitutes realization by the parent company. The change in the value of properties held in foreign countries because of the change in exchange rates should be considered as unrealized gains or losses just as changes in domestic value are considered unrealized. When a transaction converts the changed value of property into liquid form, the change in value is realized; gains may be distributed or re-employed and losses mean curtailed activities. In the foreign situation, however, the question arises as to whether a gain is realized when the foreign currency increases in value or when property held before the increase is utilized to produce currency. If the latter position is taken, the election to reinvest the proceeds in the foreign country would not destroy the realization of the gain; increases in the value of the currency balances held through the change would occupy the same position and would require a recognition of a realized gain or loss rather than the current treatment as an unrealized change. There is something to be said for the position that no gain or loss in terms of dollars should be reported in consolidated balance sheets until such gain or loss is converted into dollars.

This is equivalent to postponing the recognition of a gain in the ordinary corporate situation until dividends are declared, the investors' viewpoint. Consolidated statements do not take the investors' viewpoint but assume that the parent company is more than an investor, an owner.

A minority interest in a foreign subsidiary requires special treatment. It is contradictory to express the minority interest in terms of dollars and assign to the minority an interest in gains or losses from foreign exchange fluctuations. There will be less information in consolidated statements including a foreign subsidiary of value to the minority than in the case of domestic subsidiaries and minorities. It may be well to place the reporting stress upon the relation of the minority to the parent company investors. This approach would justify an assignment of the minority proportion of the dollar value of the surplus including the effects of foreign exchange fluctuations, "realized" and unrealized, to the minority interest regardless of the fact that the minority must be concerned with the legal surplus as reflected on the subsidiary's books in terms of the foreign currency. From the standpoint of the minority an increase in the cost of the foreign currency in terms of dollars will not decrease the cost of the use of the property held before the increase in the ratio nor will the net current assets increase in value, unless changes in the purchasing power of the currency are taken into account. A minority reduces the effect of a change in the currency ratios upon the group. Rather than treat the minority portions as unchanged in terms of dollars in the income statement and the balance sheet, it will be better to assign the

minority an interest in the changes even if it means an overstatement or an understatement of the minority interest. This course will show the dampening effect of the minority and will present the statements on a homogeneous value basis.

Some of the objection to this process can be eliminated by showing an adjunct or contra to the minority interest in surplus converted at the current rate to bring the minority interest into agreement with its share of the surplus based upon utilizations of dollar values. Similarly a special account should be set up to show the minority subtraction from unrealized gain or loss from foreign exchange fluctuations.

In those instances in which the foreign exchange fluctuations are very erratic it may be impossible to prepare meaningful statements in terms of dollars. The "realized" and unrealized gains or losses may be very large and may distort the analysis but may be rapidly wiped out or greatly increased in the next period. Little useful information could be obtained by converting Chinese dollars into U. S. dollars for statement purposes even if there were an acceptable conversion rate under the present condition of runaway inflation. In the Chinese example, however, no statement could be very meaningful in terms of any currency.

In the last two decades special restrictions upon the conversion of foreign currency and rates of conversion dictated by governmental edict have been common in many countries. Such artificial barriers as these tend to destroy the significance of the dollar representation of the foreign conditions and operations. There may be different rates of exchange set up for the conversion of dollars into the foreign currency

and for the conversion of the foreign currency into dollars and there may be unofficial rates, diplomatic rates, and outright blackmarket rates.³⁸ In many cases the official rates may be pure fiction. Again conversion may be rationed by the foreign government to such a degree that conversion of the proceeds of profitable operations cannot be made available to the parent company in the foreseeable future. In some cases there may be a presumption that the parent company has undertaken a speculative investment rather than an expansion of its productive efforts, and the best portrayal may be a reflection of the investment aspects.³⁹

Even in the case of very unsatisfactory foreign restrictions and regulations as well as unsettled economic conditions some special means of revealing the relationships of the subsidiary to the domestic parent company should be developed. Intercompany profits must be carefully examined. Elimination of intercompany profits and claims has even more justification in this case than in the domestic situation, particularly if realization of claims depends upon conversion into

³⁸"In conclusion, it may be said that no general rule can be laid down as to what rate of exchange should be used for current transactions in the consolidation of a foreign subsidiary, except that the rate chosen to reflect income should be the one at which funds can actually be transferred to the United States. Thus the choice between the official and other rates should be based upon consideration of all the facts of the individual situation, including the availability of funds from the particular country and the rate at which the parent company has been able to realize remittances therefrom." C. G. Blough, "Current Accounting Problems - Consolidation of Foreign Subsidiaries," The Journal of Accountancy, LXXXV, 162, Feb., 1948.

³⁹"As a general rule, it is believed a company should not be included in consolidation if it is located in a country whose currencies are so blocked that it is impossible to withdraw a substantial portion of its current earnings in the form of dividends and to receive payment for current shipments. It is recognized, of course, that in situations where operations are predominantly in foreign countries, adequate disclosure may require special treatment." Ibid.

dollars.⁴⁰ In the extreme case the total of all claims held by the parent may be computed and reduced to an estimated realizable value.⁴¹

In the more fortunate case in which the foreign subsidiary exports raw materials or processed goods to the parent rather than the case of a subsidiary exploiting a foreign market for the produce of the parent, the parent will be able to realize upon its foreign investment in goods. Foreign restrictions on exports and political conditions may have repercussions but the parent may be in position to recover much of its investment and advances in goods. Unless there is an expectation of confiscation or regulations which make operation very unprofitable, it will be reasonable to include these foreign subsidiaries in the consolidated statements in the regular manner.⁴²

⁴⁰"The exclusion of foreign subsidiaries from consolidation does not make it permissible to include intercompany profits which would be eliminated if such subsidiaries were consolidated." American Institute of Accountants, Accounting Research Bulletin, no. 4, p. 31.

⁴¹"I think this question of the consolidation of foreign subsidiaries is a very important one and could easily be made the subject of a separate paper. In certain cases it seems to me to be better not to consolidate and to separate the proportion of the intercompany account which may be considered as current. In other cases it may be better to consolidate but to show the new quick assets of the foreign subsidiaries as one figure, without consolidating them in detail." Brundage, op. cit., p. 289.

⁴²"There appears to be considerable support for the view that if a company's program for a foreign subsidiary contemplates continued increases in its fixed assets and capital, so that its earnings would not have been withdrawn anyway, it may be properly included in consolidation. It does not seem sound, however, that the mere fact that earnings are actually reinvested in additional plant should, of itself, justify consolidation when the funds could not have been withdrawn even if the parent had so desired. The reinvestment might have been the only choice available." Blough, op. cit., p. 162.

Summary

In many parent-sub subsidiary situations there will be special problems in combining the results of operations and distributions of the proceeds of operations. It will be necessary to eliminate intercompany sales of goods or services. Discounts, allowances, and write-offs must be disposed of to reveal the group position. Some difficulty may be encountered in eliminating intercompany operations if the statements to be combined cover different time intervals. The preparation of consolidated statements is further complicated by the fact that although the statements must show the joint operations cleared of intercompany transactions the determination of the equities of the various interests must be based upon the results of the operations of the individual companies.

Intercompany dividends will be eliminated in consolidation. If dividends on the subsidiary stock held by the parent are based upon surplus accumulated since the stock was acquired, there is some point to treating the amount as parent company surplus rather than restoring it to the consolidated surplus of the subsidiary. Dividends based upon surplus accumulated before acquisition will not affect consolidated surpluses assignable to the parent company interests. Stock dividends are capitalizations of earnings and should not result in any change in the total of consolidated surpluses.

The portrayal of surplus in the consolidated statements should be designed to show the effects of earnings upon the stockholders' equities. In many cases it will be impossible to show the dividend potentials in consolidated surplus analyses. New stock issues contributing

an excess over par or stated value tend to change consolidated earned surplus. An adjustment restoring the earned surplus to its former balance (unless there is a loss in the equity of the parent) would seem to give better continuity but would confuse the dividend position. It would not seem to be necessary to maintain the balances of surplus reserves through the eliminations if such reserves apply to the surplus at acquisition. Income taxes on anticipated future dividends will reduce the amount available to the parent company interests, requiring surplus segregations if a display of the dividend potential is desired.

Most of the problems of consolidating a foreign subsidiary are also found in consolidating a foreign branch. If the point of realization of profits is taken to be foreign cash or receivables, the fact that conversion of the surplus balance at the current rate would give a different amount from the surplus derived from the income statements can be disregarded or, at most, provided for by segregating the difference in surplus. A minority interest in a foreign subsidiary has the effect of reducing the size of gains or losses from conversion rate fluctuations. The best means of showing this condition may be to set up the minority at its proportion of the total dollar equity. Distress conditions and special restrictions in foreign countries may make meaningful consolidation impossible unless further adjustments are made to reflect the conditions.

CHAPTER VIII

INVESTMENTS OF SUBSIDIARY COMPANIES

A second step in the elimination of investments against underlying equities becomes necessary whenever ownership of securities by a subsidiary indicates that the subsidiary is itself a parent company or that the subsidiary has an interest in the parent company. Consolidation in this complex situation involves the elimination of more than one legal entity or of a reciprocal interest in two legal entities in

TABLE III

THE RELATIVE IMPORTANCE OF COMPLEX
HOLDING COMPANY SYSTEMS¹

Industry	Number of Registrants with Subsidiaries	Number with Inactive Subsidiaries	Number with Active Subsidiaries				Number of Subsidiaries
			1-5	6-20	21-50	51 & over	
Agriculture	15	1	11	2	0	1	112
Extractive	92	8	65	17	2	0	448
Manufacturing	728	67	435	159	48	19	7,804
Financial	50	1	24	21	1	3	738
Merchandising	125	7	76	32	9	1	1,101
Real Estate	11	0	5	5	1	0	132
Construction	10	3	6	0	1	0	44
Transportation & communication	30	0	17	8	4	1	381
Service	29	2	13	6	4	4	797
Electric light, power, heat, water, and gas	50	0	21	8	12	9	1,601
Miscellaneous	7	1	2	4	0	0	75
Totals	1,147	90	675	262	82	38	13,233

¹Securities and Exchange Commission, Statistics of American Listed Corporations, Part I, 1940, pp. 160-61, adapted.

order to trace the ownership-control to the underlying properties and activities. Essentially the same ideas apply to these more complex situations but new technical problems arise.

The relative importance of complex relationships may be grasped from Table III above. The study covers 1,739 registrants in 1938, of which 1,147 were found to have subsidiaries. Over half of the registrants having subsidiaries own fewer than 6 subsidiaries and over 10%, 120, have more than 20 subsidiaries. The average number of subsidiaries per holding company is approximately 12. It seems quite proper to conclude that the parent-subsidary relationship in practice often becomes a maze of corporations with related interests.

The Multiple Tier Situation

Consolidation in a situation in which the subsidiary is found to have a sufficient investment in another corporation to be in turn classified as a parent company will necessitate the tracing of the ownership of the top holding company through the first subsidiary to

TABLE IV
DEGREE OF REMOTENESS OF SUBSIDIARY FROM REGISTRANT²

Degree of Remoteness	Total Domestic Subsidiaries of Registrants	Total Foreign Subsidiaries of Registrants
One step removed from parent	7,555	1,619
Two steps removed from parent	2,155	816
Three steps removed from parent	574	191
Four or more steps removed from parent	255	68
Totals	10,539	2,694

²Adapted from Table II, Chapter III.

the accounts of the sub-subsidiary. That this condition is common enough to justify special analysis can be readily seen by examining Table IV above. Of the total domestic subsidiaries, 2,984 are two or more steps removed from the parent company, an indicated percentage of approximately 20%. It is likely that the 2,984 companies included in this analysis constitute most of the companies two or more steps removed from the parent since nearly all of the large companies must register with the Securities and Exchange Commission. Although 2,984 is a relatively insignificant percentage of the total of all corporations, the number would by itself justify an investigation of the problems involved.

Ownership-Control

It has been tentatively concluded that in the simple case of the parent-subsidiary relationship an ownership of over half of the residual stock equity of the subsidiary, held for the purpose of participating in the activities of the subsidiary as an owner, would justify, if not require, the reporting of the two related corporations in one set of consolidated statements. If corporation A owns 60% of corporation B and corporation B owns 60% of corporation C, corporation A has an indirect interest of 36% in corporation C. The question arises as to whether this 36% interest justifies the inclusion of C in consolidated statements to be submitted to the stockholders of A, B and C.³ While it may

³Should a consolidation ever be made when the equity of the controlling interest in an underlying subsidiary is less than (let us say) 50%? It is difficult to make a definite pronouncement, but generally such consolidations are extremely misleading. Consolidated balance sheets reflect the equities of the various interests but not the control. In

be said that A has the predominant interest in the securities held by B, it cannot be said the A has the predominant interest in the assets of C. On the other hand, the stockholders of C do not have the predominant ownership interest in the values held by corporation C. In order to justify the inclusion of C one must affirm that since the remaining outstanding stock of B will be presented as a minority interest in the consolidation, it will be necessary to show the associated interest of A and B stockholders in C. In other words, once the consolidation of A and B takes place, it becomes necessary to show the extension of the consolidation to C. As before, consolidation relies upon ownership-control but this ownership need not all reside in the top holding company to justify inclusion.

Acquisition of Control

There will be special valuation problems in all multiple level situations. It is unlikely that A will acquire control of B at the same time that B acquires control of C. Even if this were true, it would be necessary to investigate the relationship of the purchase prices of the two sets of securities. If the two purchases take place at different times it may be necessary to consider the effects of intervening transactions.

If B acquires control of C after A acquires control of B, it may be assumed that A determined the purchase of C and that the cost of C

the illustration offered above, the controlling interests have less than a 10% equity in the assets of the operating subsidiary D and cannot receive more than 10% of the earnings. There is, therefore, not much point in a consolidation." L. A. Carman, "Intercorporate Relationships," American Accountant, XVII, 105, April, 1932.

securities is a cost to A and B. In all cases costs incurred after control is acquired can be assumed to measure cost to the parent company. Thus revaluation of corporation C to match the cost of the securities can be carried to the consolidated statements without modification.

An acquisition of control of a subsidiary which already possesses control of another company is an acquisition of an interest in two companies. It would be difficult to imagine the purchaser accepting the cost of the securities held by the subholding company at face value if appreciable time has elapsed since the sub-subsidiary was acquired. Even if the investment of the subholding company were adjusted for retained earnings since acquisition, it would be unlikely that the adjusted investment account would reflect changing value considerations. The bid price of the parent company for the securities of the subholding company could well be based upon the consolidation procedure outlined by Montgomery:

In general, when the stock of a company which in turn owns one or more subsidiaries is acquired, the amount to be adjusted in consolidation should be computed by first consolidating its accounts with those of its own subsidiaries to determine the consolidated net assets of this group, and by then comparing the amount of such consolidated net assets with the amount paid by the purchasing company.⁴

In this last situation it may be reasonable to extend the revaluation to the properties of the sub-subsidiary as well as the subholding company. The reporting of the difference between investment cost and revised value can then be based upon the parent's equity in the combined

⁴R. H. Montgomery, Auditing Theory and Practice, p. 517, N. Y., 1940.

values of the sub-subsidiary and the subholding company. It is probable that this procedure will involve a three-way valuation of intangibles: the cost values of the minority proportion of the sub-subsidiary; the value difference between the original security cost and the comparable revised values as applicable to the minority of the subholding company; and the value difference involved in the last purchase price of securities. For amortization purposes it may be advisable to keep notations of the separate intangible valuations of the various minority interests. It should also be noted that changes in the values of the inventoriable assets and in the debt will result in appreciation or declination which applies to the two minority interests, probably in different amounts since the minority interest in the subholding company may not participate in the full value change.

Changes in the Percentage of Control

As in the simple case, only those shifts in ownership which result in a change in the proportion of the parent company holding to the total stock equity will tend to result in a gain or loss to an interest. In the multiple level case, however, it will be possible for the parent's equity to change because of transactions between the subholding company and the sub-subsidiary in addition to the previously enumerated possibilities.⁵ A change in the holding of the subholding company which produces a change in the stock equity of an amount different from the

⁵"If there are subholding companies in the consolidated group with minority interests, transfers of stocks of subsidiaries between holding companies may also affect the aggregate difference between cost of subsidiaries' stocks and their net assets at acquisition because of the change in relationship of minority interests." Ibid., p. 518.

payment will result in a change in the intangible valuation applicable to the parent company and the minority of the subholding company as well as a gain or loss to the two interests. From the standpoint of the parent company, a change in the investment of the subholding company means a shift in assets from one division of the business to another to the extent that the change came about through a transaction with the sub-subsidiary; but if the change came about through a transaction with the minority of the sub-subsidiary, the change will amount to a change in the total assets employed through an issue or retirement of stock.

Bonds and Preferred Stock

Purchases of bonds or preferred stocks of the subsidiary by the subholding company after the parent has acquired control of the subholding company will follow the pattern outlined for the simple parent-subsidiary case. If the subholding company already holds bonds or preferred stocks at the time of acquisition of the subholding company, the revaluation procedure will attribute a portion of the changed valuation as an appreciation or declination in the minority interest of the subholding company. Acquisition of the stock of the subholding company by the parent includes the acquisition of an interest in the bonds or preferred stocks of the sub-subsidiary and the price paid must be compared with the current values of the items acquired. Thus the parent company will not participate in the gains or losses in the values of these equity items in the portfolio of the subholding company at the acquisition date.

Intercompany Charges in Assets

Mention has already been made of the effect of transactions between affiliated companies which produce a markup in assets in excess of

assignable costs. In all cases it will be advisable to report the assets at cost to the group in the consolidated balance sheet in order to present costs on a harmonious basis. In order to report the "realized" portion of the gains or losses arising from these intercompany markups, it will be necessary in this case to trace the effects of the markups to the three interests. A sale by the sub-subsidiary to the subholding company at a price which differs from cost will produce a "realized" gain or loss to the minority of the sub-subsidiary which will be borne by the parent and the minority of the subholding company in the event that there is a failure to dispose of the goods or services at a price consistent with the original intercompany price. Similarly a sale to the sub-subsidiary will produce a "realized" gain or loss to the participants in the selling company's earnings to the extent that the minority of the sub-subsidiary must bear the brunt of the ultimate result.

Revenue and Surplus

Even though the parent company is not directly related to the sub-subsidiary and may be considered to have an indirect minority interest in it, the preparation of a consolidated report will require the elimination of transactions between the parent and the sub-subsidiary as well as the intercompany claims and obligations. Transactions between the subholding company and its subsidiary must also be fully eliminated on the thesis that the minority interest in the subholding company is an interest in a holding company and has no significance if divorced from the group. For example, it would be incorrect and confusing to eliminate only the parent company's proportions of the dividend charges and dividends payable of the sub-subsidiary leaving a balance due to the minority

interest of the subholding company, for the minority of the subholding company can only participate in the activities of the group through dividends declared by the subholding company.

Complex Cases

This analysis of the multiple level case has proceeded on the apparently reasonable assumption that the same consolidation principles apply as in the case of the simple parent-sub subsidiary situation. The major difference in the solution lies in the assignment of an interest in the lower levels to the minority interest of the subholding company. Regardless of the numbers of intermediate holding companies the solution procedure remains unchanged except in complexity.

There are probably many cases in practice in which there is a direct interest held by the parent company in the underlying subsidiary as well as an indirect ownership through subholding companies. In this instance consolidation will be accomplished by tracing the costs of the investments to the percentages of the revised equities held through the two channels. Different acquisition dates will, of course, complicate the problems.

An accurate portrayal of the minority interests in subholding companies depends upon the revision of values at the acquisition date of each controlling interest. Needless to say, the practicality of determining a new set of revised values each time a new top holding company is added may well be questioned. In many cases the addition of a new top holding company merely enables those in control to reduce their capital commitment in the group but leaves the same individuals in control. If there are no substantial changes in the holdings of the

residual shares which give control of the group, there would seem to be little point to considering that there has been any change in underlying values. In a similar manner the acquisition of a holding company group by a new interest in a case in which there have been no thorough revisions of values at the various acquisition dates may proceed from the revised values at the date of the top acquisition providing that retained earnings are taken into account in determining the acquisition cost differences of the minority interests in the subholding companies and providing that the excesses so determined shall be indicated to include the effects of changes in values in the interval between acquisition dates.

Reciprocal Holdings

Consolidated statements represent the ultimate value characteristics in relationship to the ultimate beneficial ownership. It occasionally happens that the subsidiary company holds an ownership interest in its parent company. In tracing the ownership to the ultimate values, one is faced with the fact that the parent company owns an interest in the subsidiary which gives it an interest in itself. No fully satisfactory means of valuing the reciprocal holding has been developed to show the investment aspects. There is some basis for the contention that the parent has merely used an indirect method to reduce its equities. It has even been suggested that the preparation of statements in this situation may well be entirely confined to consolidated statements in which the reciprocal holding becomes treasury stock.⁶

⁶Unless the intercompany holdings are so small as to be negligible, the balance sheets of members of a bilateral (or multilateral) group should never be published individually. The effect is precisely the same

After considerable investigation, Moonitz⁷ arrived at the conclusion that the individual company position could be shown by treating the reciprocal holding as if it were held directly by the parent company, assuming an exchange of subsidiary securities for securities of the parent company. While this simplification may reflect the conditions that should exist in order to protect the owners from a self-perpetuating management, it apparently does not correspond to the relationships that actually exist, particularly if there is a substantial minority interest in the subsidiary company. The profit-sharing conditions require the portrayal of the interest of the minority in the operations of the parent company.⁸ It is interesting to note that mutual ownership is sometimes accomplished by a direct exchange of

as though a company should conceal treasury stock under the caption 'Investments' - an overstatement of net worth." Carman, op. cit., p. 106.

⁷M. Moonitz, "Mutual Stockholdings in Consolidated Statements," The Journal of Accountancy, LXVIII, 227-35, Oct. 1939.

⁸"Actually, under present law, all outstanding shares of a corporation's stock, including those in the hands of subsidiaries are entitled to dividends, and share in profits and losses that may arise in final liquidation. The customary way of computing minority interests by means of simultaneous equations takes full cognizance of this fact, and therefore represents the correct method in the preparation of consolidated statements." H. S. Benjamin, correspondence, The Journal of Accountancy, LXVIII, 400, Dec., 1939.

"For determining the division of earnings and net worth, however, it would seem that the proposed method (Moonitz's treasury stock method) overlooks the fact that although the statements of the companies may be consolidated, the minority interest in the subsidiary company is interested primarily in the subsidiary company by itself. To these minority stockholders an investment in a parent company is an investment of a part of their company's net worth and could not equitably, in most cases, be eliminated merely because the parent company had as large, or larger, an investment in their company. The stock held by the parent, from their point of view, could not be considered as treasury stock in the calculation of their net worth. ...This investment only theoretically represents treasury stock to the extent that it is supported in part by the asset of its own stock held by the other company." E. B. Alford, correspondence, The Journal of Accountancy, LXVIII, 401, Dec., 1939.

securities between the subsidiary and the parent company. The assumption that the parent holds its own stock would place the accountant in the awkward position of assuming that the parent-subsubsidiary condition does not exist as the result of such an exchange. It is undoubtedly true that there is an essential retirement of the parent company stock but, by the group, not by the parent company. Consolidated statements treat all intercompany stock holdings as treasury stock but this is no excuse for treating the individual company statements as arbitrary segments of the consolidated statements. It seems unlikely that the courts will revoke the proposition that each share in a corporation participates equally with every other share in all values and activities.

The Mutual Ownership Approach

Majority ownership of residual shares has been taken as a requirement for the substitution of the underlying assets for the investment account. In the case of a reciprocal holding, however, elimination of the investment is advisable whenever an appreciable percentage is held. the reciprocal holding is an intercompany claim tending to inflate the assets and the equities of the group balance sheet. Elimination of the item will reduce the parent company's stock equity and essentially substitute the underlying assets of the parent company for the claim. The resulting consolidated statements will show only the stock held by the public as outstanding stock.

Those accountants who base their consolidation theory on the supposition that consolidated statements are prepared for the stockholders of the parent company maintain that there must be a dominant outstanding interest in one or the other of the two companies. The adoption of the

idea of an association of the two outstanding interests would make it possible to present a satisfactory solution even for cases in which the majority of each company's stock is held within the group. Probably this last case is rare. The inequities pointed out by the court in the Prudential case⁹ indicate fairly clearly that the use of mutual ownership to perpetuate management can have little standing in law, and it is difficult to find any other reason for a substantial and continuing mutual ownership.

The net values of the subsidiary which relate to the investment account of the parent company are influenced by the net values of the parent company which relate to the investment account of the subsidiary. In order to determine the net values of the parent the net values of the subsidiary must be known and in order to determine the net values of the subsidiary the parent net values must be known. Although the arithmetic approach would seem to produce an endless series of calculations, four or five trips around the circle of ownership will often produce results

⁹"The evidence produced on this motion, bearing upon the sharp question whether the establishment of this novel and ingenious scheme for the control of a great insurance company with \$60,000,000 of assets, - a scheme which has not been intentionally created by the insurance statutes of the state, - would be wise, safe, and advantageous to the Prudential Insurance Company, is extremely meager. This evidence, in my opinion, not only fails to justify a judgment of this court in approval of the scheme, but raises the gravest apprehensions that the scheme, if carried out, would be a continuous menace to the policy holders and the stockholders of the Prudential Company, which would grow more and more portentous as the years go by, and these faithful and experienced men, one by one, vacate their seats of power and give place to other men who are now unknown; that after all or almost all of the present board of directors have passed away, and the majority of the board has undergone several changes, this scheme might even destroy this great insurance company, which these present directors have created, and which now stands as a monument to their integrity, wisdom, and skill." *Robotham v. Prudential Ins. Co. of America*, 64 N. J. Eq. 673, 53 A. 842 (1903).

accurate to the nearest cent. An algebraic solution based on simultaneous equations shortens the calculation. Whenever there are more than two or three mutually related companies, even the simultaneous equation approach becomes laborious. Carman and Scott¹⁰ have developed short cuts based upon the solution of simultaneous equations by the use of determinants. The principal problems arise, not in the solution of the relationships, but in the determination of the relationships.

Acquisition of Control

A mutual interest may exist at the time control of the subsidiary is established through the prior holding of shares of the parent company by the subsidiary, or the mutual interest may be established by a purchase of parent company shares sometime after the acquisition of control of the subsidiary. Both cases involve specialized problems that require careful development.

A prior holding of the parent company shares at the time the purchase of a controlling interest is contemplated would indicate that the price paid for the shares of the subsidiary includes an amount attributable to the parent company shares. There are two different methods of determining the difference between the acquisition cost and the underlying tangible values. The simplest procedure would be to revalue the parent company securities at the market price at the date of the acquisition of control of the subsidiary (for purposes of consolidation) and attribute to the minority its share of appreciation or declination. In this case there will be a gain or loss on stock retirement for the

¹⁰Carman, *op. cit.*, 103-8, 140-2, 171-7, 204-12; D. R. Scott, "A Simplified Solution of Circuit Ratio Problems," The Accounting Review, XVIII, 99-103, April, 1943.

difference between the current market price valuation and the parent company book value. To overcome the objection that this gain or loss is occasioned by the failure of the parent company books to reflect current values rather than by a real gain or loss to be shared by the minority and the parent, it would be necessary to revise the parent company accounts to bring them into agreement with the current value at the time of the acquisition of control. If this last method were used, the subsidiary holding would be based upon the revised values and the minority would be affected by the recognition of the change through an appreciation or declination account. There would be no gain or loss on retirement in this case since it would be assumed that the parent paid the revised value for its own shares in its purchase of subsidiary shares. It should be noted that the revision of the parent company accounts should be made to agree with sound values rather than temporary market abnormalities. The first of these suggested methods would appear to be satisfactory for insignificant holdings of parent company shares or for those cases in which book value is close to market value. Either method will give substantially the same minority interest.

Suppose that P acquires a 60% interest in S ten years after S had acquired a 30% interest in P. In the ten year interval property held by P increased in value appreciably and P retained earnings for expansion purposes. The original cost of P's securities was \$50 per share, the book value is now \$75 per share, and the sound current market value is \$100 per share. The price paid for the securities of S is based upon a \$100 value for the securities held by S. Quite obviously a value of \$50 for the securities would produce a \$50 excess purchase price

for each share held to be reported as an intangible although no intangible may exist. Furthermore, elimination of the securities would give rise to the recognition of a gain on retirement of \$25 per share. Revaluation of P's securities to book value would produce an intangible valuation of \$25 per share arising from excess purchase price but there would be neither a gain nor a loss on stock retirement. On the other hand, the acceptance of the \$100 value would produce no excess purchase price because of the securities but would lead to the recognition of a loss of \$25 per share on stock retirement. The only fully realistic portrayal would eliminate intangibles and gain or loss by basing the revision of P's book values as well as the securities held by S on the \$100 current value. In this case there would be no excess purchase price or elimination gain or loss arising from the securities. With either of the two \$100 valuation methods, the minority of S will be the same but the parent company stock equity in the consolidation will be reduced by \$25 per share for each of the shares making up the 30% interest in the first case and will be increased by \$25 per share for each of the remaining shares making up the 70% outstanding in the second case.

Retirements in the case of a single company tend to produce much the same result. In this case, however, no one would suggest that a portion of the price paid for securities should be segregated as an intangible and the balance offset against stock equity. Generally the full retirement price would be offset against the book value. In the case of a substantial retirement with the book value much lower than the retirement price, there tends to be a very considerable reduction in the already

understated book value per share. Revaluation in the extreme case would be clearly required.

Revision of the parent company book values to correspond to the purchase price of the subsidiary's shares would involve the recognition of appreciation or declination for the parent company stockholders. There may be some justification for restricting the portion of any change resulting from the recognition of excess earning power to the percentage represented by the securities held by the subsidiary. In other words, the parent company revisions may follow the same pattern as the revisions of subsidiary values.

It will be observed that a prior holding of shares by the subsidiary produces nearly the same result in the ideal solution as a purchase of parent company shares immediately after acquisition.¹¹ There is a difference in that the minority interest participates in value changes since the earlier date but there is no difference in effect from the standpoint of the parent company interest. Cost to the subsidiary after acquisition may be considered cost to the parent company for the proportion of any item acquired attributable to the parent company. In order to avoid undue effects upon the parent company's stock equity, revisions of values to correspond to the cost price must always be considered.¹²

¹¹"Shares of the controlling company's capital stock owned by a subsidiary before the date of acquisition should be treated in consolidation as treasury stock purchased on that date. Any subsequent acquisition or sale by a subsidiary should be treated in the consolidated statements as though it had been the act of the controlling company." E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 67, March, 1938.

¹²"The effect is just the same as though the parent company had purchased some of its own stock for its treasury. Consequently any

A reciprocal holding established in whole or in part by issuing shares of the parent company for a new issue of shares of the subsidiary may be eliminated by treating the exchange as two transactions. The exchange may be considered to be an issue of stock to provide the funds needed to purchase shares in the subsidiary. With this assumption the consolidation proceeds as indicated except that the issue price of both types of stock may be in doubt. The results obtained will correspond to the facts - the shareholders of the subsidiary have in effect taken an interest in the parent company in exchange for a portion of their interest in the subsidiary.

It will not be necessary to resort to the simultaneous-equation method in order to prepare the original consolidated balance sheet. The cost of the subsidiary shares will be used without change in setting up the revised values of the parent company and the current value of the parent company shares will be used in setting up the revised values for the subsidiary company. The difference between the investment account and net value of inventoriable items in each case will give the amount attributable to the purchase price difference. The excesses discovered in this fashion will be carried to all subsequent consolidated balance sheets, adjusted for amortizations.

Changes in Stock Holdings

An increase or decrease in the relative proportion of the shares of the subsidiary held by the parent company will have the same effect, depending upon the circumstances bringing about the change, as in the

premium paid for such stock would be chargeable against the consolidated surplus." W. A. Staub, "Consolidated Financial Statements," Accountant, LXXXI, 737, Dec., 7, 1929.

simple case with the exception that the parent will have a different interest in itself. The elimination will produce the same excess of cost or value but the assignment of shares in the parent company's retained earnings since the acquisition will change. It will be necessary to recompute the parent company's stock equity, compare it with the equity before the change, and compare the difference with the proceeds paid or received to ascertain the net gain or loss in equity. The adjustment may be carried to the excesses rather than treated as a parent company gain or loss unless the amount can be accurately determined and is clearly a gain or loss.

There will be even more objection to revising the values of the parent company for every change in the holdings of parent company stock by the subsidiary. To avoid this annoyance, the difference between the cost or proceeds and the last revised value of the shares traded adjusted for all shares of retained earnings can be treated as an adjustment of the excess applicable to the holding of parent company shares. If the change is substantial, however, this simplification may lead to errors of important amounts.

Revenue and Surplus

Aside from the difficulty in allocating the elimination of unrealized markups, the determination of the realized revenues and assignable charges for the consolidated group will proceed exactly as before. Intercompany revenues will be offset against the corresponding charges to reveal the net sales to outsiders of the group services and the costs incurred by the group in obtaining these outside revenues.

In order to maintain the assets of the group at cost, it will be

necessary to eliminate intercompany markups included in the individual company accounts against the surpluses attributable to the parent and the minority. A sale of an asset by the subsidiary to the parent at a markup over all costs will produce a profit for the subsidiary in which the parent participates. The parent's share produces a profit in which the subsidiary participates. Simultaneous equations will indicate the shares assignable to each of the interests. In a similar manner, a sale by the parent to the subsidiary at a markup will produce a tangle of interests in the gain. If it is desired to follow the method of treating a portion of the markup as realized, it would be necessary to solve for the allocation of the loss in the event that the ultimate disposal does not cover the markup. That portion of the markup which is realized by an interest regardless of the final outcome may be added to the interest (or left in the equity in the process of elimination) and treated as a special asset.

To illustrate the elimination procedure where an intercompany markup is included in an asset, it may be assumed that the parent company owns 80% of the subsidiary company's stock and the subsidiary owns 30% of the parent company's stock. The subsidiary sold an asset which is still held by the parent at a markup \$1,000 in excess of cost. Letting P stand for the parent company's share of the profit and S stand for the subsidiary's share, one may solve for the allocation to the parent and

minority interests:

- 1. $P = .8 S$
- 2. $S = 1,000 + .3 P$
- 3. $S = 1,000 + .3 \times .8 S$ substituting for P in 2.
 $S = 1,000$
 $S = 1,000$
 $S = 1,315.79$
- $P = .8 \times 1,315.79$ substituting S from 3. in 1.
 $P = 1,052.63$

The share to be allocated to the outstanding parent company stock may be found by multiplying .70 times \$1,052.63 to give \$736.84. The share of the minority in the subsidiary may be found by multiplying .20 times \$1,315.79 to give \$263.16. The sum of the two allocation gives \$1,000.00, the total markup. If it is now desired to find the realized markup, it will be necessary to solve for the value of P', the share of the parent company in a failure to realize the markup, and S', the share of the subsidiary in this loss:

$$P' = 1,000 + .8 S'$$

$$S' = .3 P'$$

$$P' = 1,315.79 \quad \text{solving as above}$$

$$S' = 394.74$$

Parent stockholders' share (.7 x 1,315.79)	\$921.05
Minority share (.2 x 394.74)	<u>78.95</u>
Total possible loss of markup	\$1,000.00

From this it can be seen that the minority will gain (\$263.16 - \$78.95) \$184.21 regardless of the final outcome, and that the parent will bear the brunt of this gain (\$736.84 - \$921.05) in the event the markup is totally unrealized. If the sale had been in the opposite direction, exactly the reverse would have been found.

The analysis given in this illustration indicates the steps to be

followed in allocating retained earnings to the two interests. The total surplus to be assigned to the parent company stockholders will be discovered by taking the percentage of the outstanding parent company stock in the hands of the public times the parent company surplus and the parent company's share of the total subsidiary surplus. The amount of the surplus assignable to the minority will be found by multiplying the minority percentage times the subsidiary surplus and the subsidiary's percentage of the total parent company surplus. Each of the surpluses mentioned refers, of course, to surplus since the date of the acquisition of the stock or of the control of the subsidiary whichever is later with proper consideration for the elimination of inter-company gains and losses.

There are few unique dividend problems in the mutual holding company situation. Dividends in either direction from surplus accumulated prior to the acquisition of the stock should result in a reduction of the carrying value of the stock, but will affect the consolidated statements only as such dividends reduce the equity of the minority interest. Stock dividends may affect the arrangement of the stock equity section of the consolidated statements but will leave the general picture unchanged. The parent company's investment account will be modified by stock dividends of a different class in the same manner as outlined for the simple case.

With the introduction of the mutual ownership condition, the declaration of cash dividends from earnings since acquisition becomes rather complex. When available surplus and funds serve as the basis for dividends, the parent company will declare and pay a dividend on the stock

held by the subsidiary. The subsidiary in turn will consider the funds and surplus thus made available as the basis for dividends to be declared and paid to the parent company and the same funds become available for a new dividend by the parent. There will be a reduction each time of the funds and surplus within the group by the amount paid to the public until in the final step the amount available for dividends becomes insignificant.¹³ By following these steps through before the dividend declarations, the original declarations can be set up to accomplish the final result, but it may be found that, in cases of a substantial holding of the parent company's stock by the subsidiary, the original declarations would need to exceed the amount of legally available surplus in order to be sufficient for the purpose. When a significant mutual holding is found, it may be that the consolidated balance sheet and earnings statement give a better idea of the dividend potential than the individual statements.

It has been proposed that the stock of the parent company held by the subsidiary should not have voting or dividend rights.¹⁴ There

¹³See Accountant, LXXXVIII, 566, "Intercompany Profits."

¹⁴"If a dominant company holds, directly or indirectly, all the outstanding shares of a group, identical results are obtained whether the conventional simultaneous-equation method or the proposed treasury stock treatment is employed. In the presence of outside shareholders, however, the amount of a subsidiary's profits accruing to controlling and minority interests depends upon the method chosen. ... When shares are reacquired through the medium of a controlled subsidiary ... the law is silent or contradictory and accounting practice views with seeming complacency the spectacle of a corporation in effect voting its own shares and directing the payment of dividends on them." M. Moonitz, The Entity Theory of Consolidated Statements, pp. 75 & 77, American Accounting Association, monograph no. 4, Chicago 1944.

"It is sometimes suggested that mutual stockholdings should be interpreted as treasury shares - shares without voting rights and not entitled to participate in dividends. This suggestion cannot be fully adopted, however, as long as the rights of the corporate stockholder to

may be some point to denying voting rights to the directors of the subsidiary but it would appear entirely inequitable to deny to the minority the right to participate in the share of earnings fairly attributable to the stock held by the subsidiary. There can be no question but that the minority has made a contribution to the parent company, and there should be no question that the minority has a right to realize on that contribution.¹⁵ There is some validity, however, in the position that the minority is in the position of an investor with respect to the stock of the parent held by the subsidiary. While it may be true that the minority has an equity in the total surplus position of the parent, the minority has no effective control over the actions of the parent company. It must always be remembered that the share of parent company earnings assigned to the minority does not constitute legally available surplus until such earnings have been appropriated for dividends. The elimination of the stock of the parent and the substitution of the underlying values does not rely upon the control exercised by the subsidiary but upon the control exercised by the parent. The equity of the parent company stockholders cannot be correctly presented unless the full equity of the minority is segregated. Consolidated statements demand the elimination of all intercompany claims.

Those accountants who believe that a company can invest in its own securities may argue that the investment should be considered as an asset producing a return somehow unrelated to the group activities.

receive dividends remain unimpaired from a legal point of view." W. A. Paton, Advanced Accounting, p. 788, N. Y., 1941.

¹⁵See W. A. Paton, Accountants' Handbook, pp. 1101-4, N. Y., 1943, for a comparison of the treasury stock and simultaneous-equation approaches.

Even if this position is watered down to treating the security as a contra to the parent stock equity, the obvious unsoundness of the thesis clearly outweighs the ease of accomplishing the consolidation.

Bonds and Preferred Stock

The investment portfolio of the subsidiary may include parent company securities other than common stock. The solutions of the inter-relationships arising when the subsidiary holds participating preferred stock do not vary in principle from those of the common stock case already discussed. An investment in a security with a fixed or limited rate of return, however, produces some new problems.

If a subsidiary company holds bonds of the parent company, the consolidation will treat the holding as a retirement of an obligation of the group. The retirement price will be the market value of the bonds at the date of the acquisition of the control of the subsidiary if the bonds were held prior to control, or the cost price of the bonds if the bonds were acquired after the control became effective. Through the life of the bond issue the subsidiary company will receive interest on its investment at the effective rate indicated in the purchase price and the parent company will bear interest charges at the effective rate determined by the original issue price. If the purchase was at a price less than the original issue price, the subsidiary will take up in its earnings through the life of the issue the difference as interest revenue. A cost of more than the issue price will result in earnings less than the charges borne by the parent. In effect, the difference between the issue price and the retirement price will affect the subsidiary's surplus directly and the parent company's surplus indirectly. The gain or loss

on retirement comes about through a payment to an outsider of an amount which differs from the issue price. If the gain or loss on retirement is treated as a subsidiary item in the consolidation eliminations, the minority will be attributed a gain or loss which amounts to a gain or loss arising from getting more or less interest than they would have been entitled to if they had acquired the bonds earlier, not the usual basis for recognizing a gain or loss in accounting. On the other hand, if the gain or loss is attributed to the parent company by adjusting the bonds to the price paid, the minority will be unaffected although the minority will share in the effects of the price difference through the interest element. In the nature of the case, the parent can have no direct gain or loss since a gain would mean a reduction of the debt, producing an increase in interest charges from the individual company, viewpoint which will eventually offset exactly the amount of the gain, and a loss would reduce the effective interest charges to offset the amount of loss.

Elimination of the interest earned on the subsidiary books against the interest charges on the parent company books will require an adjustment of the interest earned to the amount of the interest charges as a realization of the gain or loss on retirement. No problems will be involved other than those mentioned in the earlier bond case unless the subsidiary also holds common stock of the parent.

Preferred stock held by the subsidiary must be eliminated against the total book value of the preferred. Non-participating preferred stock cannot be considered to share in excess earnings unless the dividend requirement is excessive and it can therefore be assumed that the price

paid cannot be influenced by excess earning power. The difference between the price paid and the book value is gain or loss on retirement from the standpoint of the consolidated statements. It appears that the minority participates in any gain since the minority has obtained a share in the activities of the parent at a price less than the claim of the original holder and similarly the minority would lose if the price paid is more than the claim attributable to the stock.

Complex Cases

It is felt that the principles discussed in connection with the ownership of parent company equities by a single subsidiary will apply without modification to the more involved reciprocal ownership cases. The only real difficulty involved in adding subsidiaries and establishing reciprocal holdings between the subsidiaries lies in tracing the interrelationships and constructing simultaneous equations to express the relationships. For example, the parent company may hold shares in two subsidiaries which in turn hold shares in each other. Since the surplus of each subsidiary depends upon the other subsidiary, it will be necessary to determine the surplus of each before the parent company's share of subsidiary surplus can be determined:

$$\begin{aligned} P &= aS + bS' \\ S &= c + dS' \\ S' &= e + fS \end{aligned}$$

The parent company may also be in control of several layers of subsidiaries and one or several of the subsidiaries may have an interest in the parent and in other subsidiaries. The tangle of ownership could be made so complex that solution would be very difficult if not impossible, but it is not likely that any relationships exist that are beyond solution.

The main objection to these complicated organizational patterns rests, not in the mathematical procedure, but in the difficulty of seeing clearly in the resulting statements the outcome of the many assumptions necessary to the preparation of any consolidated statement.

Summary

Investments of subsidiary companies sometimes indicate that the subsidiary is itself a holding company or has a special interest in the holding company. This ownership aspect in turn must be eliminated in order to trace the ownership to the properties and activities which support the ownership and give it a reward. It appears that the sub-holding company situation is common in practice but no statistics are available to reveal the relative importance of significant reciprocal holdings.

When a minority interest exists in each level of a multiple tier organization, the parent company's interest in the lower levels is somewhat smaller than its interest in the immediate subsidiaries. In some cases the top parent may have an interest in a sub-subsidiary of considerably less than half of the residual stock. Yet in each case the consolidation of the immediate subsidiaries requires the extension of the consolidation to the lower levels. The conclusion is that companies may be included if a majority of their stock is held within the group of affiliated companies.

The multiple tier arrangement is generally subject to the same analysis as the simple parent-subsubsidiary scheme but there are a few unique problems. The acquisition of ownership-control of a holding company gives the acquiring company control of two companies. For convenience and

harmony in the portrayal it will be necessary to consider the new organization as being formed at the date of acquisition by the top holding company. Subsequent additions of new subsidiaries on the lower level will be treated as additions to the group at the actual acquisition date. If it is remembered that the minority interest in a subholding company is an interest in a parent company and that its interest may differ proportionately from the interest of the top parent because of different acquisition conditions, the adaptation of the general principles of consolidation to this special situation will follow without undue difficulty.

A holding of parent company stock by a subsidiary not only gives the minority interest in the subsidiary an interest in the parent but it also gives the parent an interest in itself. There is a circle of ownership in this case that appears to have no end. Fortunately the ownership results may be readily discovered by the use of simultaneous equations. A thorough treatment of the interrelationships would require a revaluation of the parent company's inventoriable assets at the time a significant interest is acquired by the subsidiary company or the date of the acquisition of the control of the subsidiary whichever is later.

Objections to treating the stock of a parent company held by a subsidiary as outstanding stock appear unsound for the stock must at least share in earnings to justify the use made of subsidiary funds. It may be desirable to forbid such stock relationships, but if such stock relationships are found to exist, equities can be protected only by insisting on the full contract rights of the subsidiary.

CHAPTER IX

THE STATEMENTS

Two approaches to the problems of portraying the conditions and activities of a parent-subsidary relationship are possible. The English, on the one hand, have been prone to modify the individual parent company statements to reflect the major subsidiary elements. The American method of reporting, on the other hand, is based upon a special set of statements for the group activities and values to articulate the individual company statements. The legal entity of corporations serves to erect legal barriers within the pool of values and profit-making endeavors which tend to relate contractual claims to separate compartments. Unless the court chooses to ignore the entity, the corporation is just as real as the parent-subsidary association. If the accountant prepares individual company reports for all member companies that have equities held by the public and consolidated statements to show the group position, the legal and economic facts will be available to all parties.¹ Moreover, the consolidated reports will thus be freed to a degree from the very perplexing problems of relating the diverse equity elements of the group to the property elements. There can be no excuse, however, for misstating any amount in order to simplify the general picture. In the final analysis consolidated

¹"...although consolidated reports are necessary to a full disclosure of financial and operating results, such statements also tend to conceal information regarding the companies consolidated which is important not only from the standpoint of regulation but also to stockholders, banks, investors, and others." W. H. S. Stevens, "System Consolidated Reports for Steam Railways," Interstate Commerce Commission - Bureau of Statistics, p. 17, July 1, 1937.

statements must give valuable supplementary information to those who have claims against companies related by the ownership-control factor.

The Form of the Statements

Consolidated statements are supplements to individual company statements in the sense that primary reliance must be placed upon the individual company statements by the various ownership interests. This is not to say that the information set forth in consolidated statements is necessarily less important to the problem of discovering the position and prospects of a company. In many instances the most important factor, earning power, cannot be adequately displayed in individual company statements.² An investor in a company related to other companies is entitled to enough data to enable him to evaluate his position in his own company and in the group.

It sometimes may appear that the information of special group values could be displayed by submitting statistical studies to point out group relationships. Although there is nothing sacrosanct about the form of the balance sheet and the income statement, there appear to be good reasons for using these statistical forms. In the first place, a reduction of the information concerning physical and ownership

²"Suffice it to say that I am an advocate of the consolidated form of statement and believe that it affords a comprehensive view of the financial position and operations of a group of companies that cannot be obtained by analyzing and comparing a number of individual statements." P. F. Brundage, "Some Shortcomings in Consolidated Statements," The Journal of Accountancy, L, 285, Oct., 1930.

"The consolidated profit and loss statement summarizes without duplication or omission all of the operations of the parent, whether carried on directly by the parent itself or indirectly through the subsidiary." E. J. B. Lewis, Consolidated Statements, p. 55, N. Y., 1942.

characteristics of value can only produce an incomplete picture of the whole. In the second place, if statistical schedules are to supply the same information, they will be better understood in the conventional statement forms. In the third place, there is something to be said for a double entry display which will by its form indicate an attempt to set forth the whole picture. Finally, the use of consolidated statements, as an essential part of the report, makes it possible to devote the parent company statements to the corporate picture without concealing important information in obscure schedules.

The English have achieved a moderate success in portraying the significant group relationships in the parent company reports. There seem to be some indications, however, of increasing support for the American system. Cluttering up the parent company statements with additional but necessarily incomplete information about the subsidiaries tends to result in a poor display of the essential equity contracts and an inadequate picture of the group.

It seems reasonable to conclude that consolidated statements should be prepared in the usual balance sheet and income sheet forms with additional schedules to bring out other effects of affiliation. Considerable ingenuity may be required in many cases to adapt the forms to the special problems involved in parent-subsidary associations.

Assets

If the balance sheet is to achieve its maximum usefulness, there should be a fair degree of homogeneity of value among the assets. It has been pointed out on numerous occasions that there should be revisions of values to place the parent and subsidiary companies on a consistent

basis with respect to inventoriable assets. Value differences arising from the suggested treatment of intangibles and possibly realized inter-company gains should not disturb the relationships if they are properly captioned and segregated.

But more than harmonious values are needed to give meaning to diverse types of assets. It is generally possible to arrange the assets of a vertical or horizontal system in a manner that will give an insight into the nature of the physical values dedicated to the group activities, but it may be impossible to accomplish a thorough-going combination of the assets of such unrelated enterprises as a factory and a bank. Several devices are available to facilitate the assortment of heterogeneous items into a significant pattern.

Consolidation of accounts is not desirable unless there is an exercised ownership-control which enables a company to participate in the activities and values of another company not as an investor but as an owner. There is a strong presumption that an investment in a company totally unrelated to the owning company does not meet the general requirements for consolidation. It is possible that a substantial investment in another company may have been made for investment purposes rather than to affiliate the two companies. On the other hand, the dissection and separate incorporation of the various phases of a business enterprise may produce subsidiary companies of a seemingly diverse character. If a subsidiary is formed to handle the accounts and notes receivable, it becomes a finance company and the question arises as to whether a finance company should ever be combined with a manufacturing company. Similarly, a separate company may be formed to provide and

operate buses for the transportation of company employees to and from work. Often those activities which seem perfectly natural for a single company to perform seem totally unrelated activities when performed by separate but affiliated companies. There is a tendency, of course, for these segregated functions to evolve into general finance companies or transportation systems which serve a wider purpose than that of their original design. Often factories and mines in isolated communities operate bowling alleys, hotels, restaurants, grocery stores and a multitude of other services for the benefit of employees and customers. Most such services are small scale and would not materially affect the statements whether they were included or excluded.

When the indications are strong that complete amalgamation of the assets would confuse rather than inform, those elements which tend to distort can be set out in a special section of the assets. One means of showing the use to which the items are dedicated might be the subdivision of the plant section into extractive, manufacturing, merchandising, and service subsections whenever the system includes these items. Or if the various items are combined, a schedule may be submitted to show the characteristics of the plant assets. A subsidiary whose activities are totally unrelated to the system might be displayed by placing a condensed analysis of the plant assets and possibly the current assets between the current assets and the plant assets. A banking subsidiary or a foreign subsidiary subject to exchange or other restrictions may require the offsetting of liabilities in order to insure the proper interpretation. In general, however, current assets of a domestic non-banking subsidiary are a part of the current assets of the system and

are as available for general use as the current assets of any other member company. Similarly the debt of such a subsidiary should be included in the debt structure of the system. To the extent that the lack of integration with the system makes it likely that the subsidiary can be dispensed with more readily than the other more closely related subsidiaries, there may be some point to excluding the current assets and debt from the general pattern.

It must be remembered that reliance is placed upon the individual company statements to reflect the investment aspects of security holdings. Relieved of this necessity the consolidated statements are free to pick up the ultimate underlying values. There appear to be advantages in placing a majority investment in a non-consolidated company held for long-term purposes on an accrued value basis in the consolidated balance sheet regardless of the relationship of the company to the parent.

Equity Arrangement

An elaborate holding company system will embrace a multitude of diversified claims.³ Rather than attempt an extended marshalling of

³This form has the advantage of presenting a comprehensive view of the facts but it is open to serious objection, so far as the statement of assets and liabilities is concerned, in that the inference apparently to be drawn from the form is that the creditors, secured and unsecured, of the several companies forming the combination, have a common fund, namely the aggregate of assets of the combination, to look to for the payment of their debts, which is not the fact. A further serious objection exists where the subsidiaries or some of them, are not wholly owned. It is necessary in such cases when preparing combined statements, to deduct from the aggregate earnings a sum to represent the share of the outside interests in those earnings and to set up a liability upon the combined statement of assets and liabilities to represent the interest of outside shareholders." A. W. Wyon, "Holding and Subsidiary Companies - Accounting Principles Involved in the Treatment of Earnings and Valuation of Holdings," Accountant, LXXXIX, 226, Aug. 5, 1933.

the claims or offsetting of the claims against the underlying resources, the accountant probably should try to simplify the picture to show the over-all obligation proportions. Certain assets may be freely shiftable for legitimate purposes between the affiliated companies, and, on this account, the general strength of the system may be best indicated by showing the total assets and the total claims separately. In some cases, however, resources cannot be shifted for any reason and claims cannot be extended to affiliated resources. A manufacturing company which owns control of a bank might possibly come to the assistance of the bank in a temporary emergency, but such a contingency would probably be unimportant in view of the nature of the current resources likely to be held by the manufacturing company and the safeguards in the present banking system.

Banking regulation would make significant loans by a bank to a stockholder virtually impossible. Even the difference between the assets and liabilities of a bank cannot be considered as more than a part of the long-run strength of the group. In such a case a display of the assets in a highly condensed manner with the liabilities shown contra may give a clearer picture of the real effect of the investment on the group, although offsetting of liabilities against assets should generally be roundly condemned.

The content and arrangement of the equities in the consolidated balance sheet should be based upon the use to be made of the balance sheet. Apparently two major points can best be set forth in the consolidated reports with respect to the liabilities. First, the ability of the system to weather prolonged slumps in general business conditions

may be more nearly reflected in the group portrayal than in the individual statements. While there must be a modicum of "every man for himself" even in this case, unusual strength in the group resources will tend to indicate staying power for at least the major components of the system. Second, the relation of the liabilities to the stock equity will give a general idea of contributions of the various types of equity-holders which cannot be grasped from the individual statements because of the intercompany investments and claims.

Since the accountant is striving for a general picture, no attempt need be made to relate mortgages and other special liens to the property elements covered.⁴ It is perhaps unfortunate that the consolidated balance sheet may indicate superior security for such claims by combining mortgaged and unmortgaged property. The situation may be alleviated somewhat by inserting a parenthetical note to the effect that certain liens attach to a restricted area of values.⁵

The stock equity of a holding company system is divided into two parts whenever a minority interest exists. The question of whether to

⁴"In considering this question (how to show collateral where subsidiary stock is pledged for a bond issue of the parent), it should not be overlooked that consolidated balance-sheets do not usually purport to set forth the relative positions of different classes of creditors." W. A. Staub, "Some Difficulties Arising in Consolidated Financial Statements," The Journal of Accountancy, LIII, 26, Jan., 1932.

⁵"When mortgage and collateral trust note issues of the parent are secured by the stocks and/or obligations of subsidiaries, current practice does not show on the balance sheet the various collateral securing such issues. This practice is not in keeping with the fact that the consolidated balance sheet does not usually purport to set forth the relative positions of different classes of creditors. However, it is entirely practical to mention the pledged securities as a footnote to the consolidated balance sheet or in the description of the liability on the consolidated balance sheet." G. H. Newlove, from manuscript titled, "Consolidated Statements," ch. 3.

treat the minority interest as a part of proprietorship or as a special element outside of the capital stock and surplus is important in establishing the principles to be used in determining the amount of the minority interest, but once the amount of the minority interest is determined, there is little difference in the portrayal emphasis merely because the stock equity title is shifted up a few lines or down a few lines. For the sake of consistency with the individual statements which show the minority interest as a stock equity, the minority might well be treated as the first element in the stock equity division.⁶

The minority interest subdivision should be set up to show the amounts attributable to preferred stocks and common stocks but cannot show the amount of minority equity for each subsidiary in a moderately complex system without unduly complicating the balance sheet. Consideration should be given to the possibility of presenting information which will enable the minority to appraise its position in the system. A supporting schedule showing the minority components may be of some value,

⁶The minority interest "...does not represent a debt payable at a fixed or determinable future time. Neither should it be shown in the net worth section because that position would indicate that the minority shared in the consolidated equity and would not, therefore, be a correct presentation of the facts." Lewis, op. cit., p. 53.

"Of the authorities who gave a classification for the minority interest, 8 held it was a liability and 14 held it a net worth item. The decision is close, because the minority interest is legally a part of net worth yet from the points of view of the majority interest and of business operation it is a liability. The present writer believes it is less confusing to show the minority interest as a net worth item than as a liability; however, he believes it is wiser to dodge the point and have the Liability and Capital section of the consolidated balance sheet have the following captions: Current Liabilities; Deferred Credits to Income; Fixed Liabilities; Minority Interest; Majority Interest." G. H. Newlove, from manuscript titled, "Consolidated Statements," ch. 3.

but the primary use of the information pointing out the importance of the minority probably lies in the analysis of the parent company stock interest.

The stock elements may be broken down to show the amount of the minority preferred stock equity and common stock equity at par or stated value and the amount of surplus attributable to each.⁷ It would seem advisable to segregate surplus arising from value revisions. If this scheme were followed, the minority section would consist of five items at the most, not an undue amount of data if it be assumed that the minority is significant in size and the equity composition is of some value in the analysis of the statements.⁸

By all odds the most important part of the consolidated balance sheet is the section dealing with the majority or parent company stock interests. It is here that the principal inadequacy of the individual company balance sheets receives consideration and correction. In order to dovetail the consolidated and individual balance sheets, the stock equity should start with the items on the parent company balance sheet in the same form and amounts if possible and show the accrued interests of the parent company stockholders in the surpluses of the subsidiaries as final items.⁹ Unrealized parent company profits and adjustments of

⁷"Where the earned surplus is in part appropriated, and the capital surplus is partly available and partly unavailable for dividends, it may be inexpedient to show the minority capital in detail. In such cases the minority interest in the surplus is shown in one amount." S. Walton and C. H. Langer, Advanced Accounting, L33-1, Chicago, 1934.

⁸"If the separate statements for the constituent companies are given along with the consolidated statements, the detailed information as to the minority interests need not be given." G. H. Newlove, from manuscript titled "Consolidated Statements," ch. 3.

⁹"The capital and surplus of the dominant or parent company should be presented separately as the primary section of the consolidated

profits or losses on transactions in subsidiary securities and some other items will modify the parent company surplus, but an informative correlation could be established by showing these items as contras or adjuncts. No analysis of the surplus arising in the subsidiaries will be necessary in the consolidated balance sheet if the income statement is properly constructed or if a separate analysis of this surplus element is submitted.

The accounts to be displayed for the minority and the parent company interests should be designed to relate each interest to the group situation. It will be difficult to present the relationships effectively for even a moderately complex holding company system without further elaboration. Rather than confuse the reader by an undue extension of the stock equity section, the accountant may decide to simplify the portrayal of the interests in the consolidated balance sheet and present supplementary information in footnotes or supporting schedules.

There is much to be said for reporting one figure for each main stock-equity interest.¹⁰ It was pointed out in Chapter VII that surplus does not have the same meaning in a consolidation as in a single corporation. Growth rather than dividend potential receives the emphasis. Moreover, economic aspects are stressed in the group statements and economic capital will often differ from legal capital. One figure reporting would make it clear to the management that individual statements must be supplied, and the reader would be led to place more reliance upon

stock equity. The share of the dominant company in subsidiary surplus or deficit accruing after date of acquisition should be clearly labeled and presented as a supplementary section of the stock equity." W. A. Paton, Advanced Accounting, p. 803, N. Y., 1941.

¹⁰This modification was suggested by W. A. Paton.

individual statements. While the simplification of the balance sheet would more clearly set forth the asset equity relationships, the elaboration of the stock equities in supporting schedules could bring out reserve requirements and other restrictions which can not be adequately handled in the limited space available in the balance sheet. It may be that the less formal handling of the equity composition will simplify the consolidation although the same elements should be shown.

Consolidated balance sheets are particularly effective in those cases involving intercompany guarantees of interest and dividends and other obligations. Discounting of receivables between affiliates and endorsements of notes payable issued by an affiliated company are variations of the same thing. Such relationships are difficult to reflect on individual company statements, but the consolidated balance sheet shows not only the effect of the contingencies upon the guarantor but also the protection afforded to the interest receiving the endorsement. Furthermore, consolidated statements are more valid in such cases for the display of claims without regard to the company issuing the claims tends to correspond more nearly to the general nature of such claims. There is still the possibility of overstating the security behind certain claims whenever subsidiaries are included which do not participate in the guarantee. No display of the endorsement or contingent liability arising from discounting is required in the consolidated reports because all of the obligations are included and none of them will require more than one payment.¹¹

¹¹"Intercompany contingent liabilities and receivables have no bearing on the position of the affiliated enterprises viewed as a whole, and hence need not be shown or referred to in the consolidated balance sheet," Ibid., p. 773.

H Company and Subsidiaries
Consolidated Balance Sheet
Date

Assets

Current assets (excepting segregated companies)

Cash on hand and in banks
Marketable securities
Receivables (outside only)
Inventories
Less Allowance for intercompany markups
Prepayments
Total current assets

Investments

Sinking funds, etc.
Shares of companies (less than control)

Segregated subsidiaries

Chinese subsidiary (at ultimate realization value)
Subsidiary bank
Primary reserves
Secondary reserves
Other assets
Less Deposits and other obligations

Cost All. for depr. Net value
 or depl.

Plant assets

Extractive
Land
Natural resource
Buildings and equipment
Manufacturing
Land
Buildings and equipment
Merchandising
Land
Buildings and equipment
Services (employee and customer)
Land
Buildings and equipment
Total plant assets

Patents

Plus Excess of acquisition cost
Excess cost of subsidiary shares over revised values - unamortized
Intercompany markups effectively realized

Total Assets

Equities

Current liabilities (excepting segregated companies)

Accounts payable (outside only)
Notes payable (outside only)
Accrued interest (outside only)
Other accruals (outside only)
Dividends payable (outside only)
Advances by customers (outside only)
Total current liabilities

Long-term liabilities

Mortgage bonds (see notes and individual reports)
Collateral trust obligations (see notes and individual reports)
Total long-term liabilities

Total liabilities

Stock equities

Minority interests in subsidiary companies
Preferred stocks (at par or stated values)
Plus Accumulated dividends and shares of
retained earnings
Common stocks (at par or stated values)
Plus Share of retained earnings
Appreciation arising from value revisions

H Company stock interests

Preferred stocks
Common stock
Earned surplus of H Company
Less Unrealized markups and profits on sales
of subsidiary equities
H Company share of subsidiaries' surpluses

Total Equities

The above proposed form for consolidated balance sheets is merely a general pattern and must be adapted to the specific peculiarities of each holding company system.

If the minority interests are segregated in a similar fashion in the individual company reports, it will be possible for the minority to make an interpolation to determine its relative position in the consolidation. There is, of course, little community of interest among the

minorities but such an analysis may nevertheless indicate the degree or firmness of the holding by the parent. It would also seem that this display would be useful to other parties and would give a clue as to the amount of intercompany participation since acquisition.

There are three major phases to the preparation of good consolidated balance sheets. The individual reports should be designed to accompany and dovetail with the consolidation. The consolidated balance sheet should be complete enough to present the whole picture of the system without undue reliance upon the individual reports. Liberal references should be made to individual reports and footnoted elaborations to clarify the positions of the various equity elements.

Income Statement Arrangement

Consolidated income statements attempt to show the profit-making activities of the holding company system. Subdivision of revenues and expenses according to the types of activities carried on by the group may be obscured by the elimination of intercompany sales and cost of sales. Individual company income statements will serve the purpose of showing the different types of activities to the extent that the individual companies are natural segments of the total. Thus the consolidated income statement will show the resultant revenue from vertical integration at the point of disposal of the goods to a party unrelated to the affiliation, but there may be a break-down by types of goods and services rendered to outside parties.

Occasionally subsidiaries may be set up to segregate employee and customer accomodation functions with the intent that such subsidiaries are to be operated at a loss and that the parent company will

defray the losses. All of the claims against such subsidiaries will, of course, be held by the parent. Reporting of the revenues and expenses in this situation may well take the form of a net portrayal of a loss as an expense attributable to promotion or employee morale, as the case may be.

With perhaps some minor adjustments the revenue, expense, loss, and tax sections will present no peculiar reporting problems. It may be well to footnote the tax section to indicate that the current earnings are subject to an additional income tax before they become available to the parent company.

An unqualified inclusion of a subsidiary in the balance sheet should be accompanied by an unqualified inclusion in the income statement.¹² Analyses relating the balance sheet and the income statement will make it necessary to treat excluded subsidiaries consistently in the two statements. If liabilities of a subsidiary are offset against its assets and the relation between net income to investors and total assets is to be used, it will be necessary to include the net after interest of this subsidiary in the "net income to investors" or to subtract the net value of the subsidiary from the total assets before making the comparison. The first of these alternatives seems to give

¹²The financial statements included in the annual report of General Motors Corporation contain one feature not usually noted in corporate statements. The summary of consolidated income includes an item in the amount of \$7,000,000, described as General Motors Corporation's equity in the undivided profits or losses of subsidiary companies not consolidated. A note appended to the consolidated surplus statement informs the reader that earned surplus includes \$33,000,000 for earned surplus of subsidiaries not consolidated, and a further amount of \$1,700,000 for net earned surplus of companies less than 50 per cent owned, but in which a substantial interest is held." W. D. Cranstoun, "The Commentator," The Journal of Accountancy, LXVI, 191, Feb., 1936.

a more complete picture and corresponds to the basic reasons for the exclusion.¹³

Some very annoying problems are involved in presenting the interest charges and dividends as well as the analysis of surplus. The apportionment of "net income to investors" should proceed according to the type of claim held by the parties who share the income. In many holding company situations the order of deduction may vary from that found in single corporations.¹⁴ If the parent's holdings consist of common stock, the interest and preferred stock dividends of the subsidiary will take precedence over the interest charges of the parent company with respect to the income of the subsidiary. On the other hand, it is not quite correct to deduct interest charges and dividend requirements on preferred stock from the consolidated net income before deducting the parent company interest charges, because the parent

¹³"A combination method is sometimes employed under which companies owned over a certain percentage, e.g., 85 per cent, are consolidated, while other majority-owned companies are not consolidated, but the parent company's equity in surplus since acquisition of the non-consolidated subsidiaries is included in 'consolidated surplus' and the equity in undistributed current income is included in 'consolidated net income'. This may be accomplished by valuing the investments in such non-consolidated subsidiaries on the books of the parent company at cost plus the equity in undistributed earnings since acquisition." M. B. Daniels, Financial Statements, p. 86, American Accounting Association, monograph no. 2, Chicago, 1939.

¹⁴"In a holding company system the preferred stocks of the important operating subsidiaries are in effect senior to the parent company's bonds, since interest on the latter is met chiefly out of dividends paid on the subsidiaries' common stocks. For this reason subsidiary preferred dividends are always included in the fixed charges of a public-utility holding-company system. In other words these fixed charges consist of the following items, in order of seniority:

1. Subsidiaries' bond interest.
2. Subsidiaries' preferred dividends.
3. Parent company's bond interest."

G. Graham and D. L. Dodd, Security Analysis, p. 178, N. Y., 1940.

company interest charges may take precedence with respect to a part of income.¹⁵ While it is possible that the proceeds of earnings may be used to discharge interest obligations which do not apply directly to that income, the shares of the various interests in income will be more clearly seen if they are applied to the income sources to which they must ultimately look for satisfaction.

It would seem that all shares of income of the subsidiary interests not held by the parent should be deducted from the consolidated net income before deducting any income shares of the parent company. In this manner the interest and dividend coverage for the parent company equities will be set forth. Unfortunately, this method will tend to show the subsidiary shares of income as prior deductions from consolidated net income¹⁶ and will not show the total interest and

¹⁵"This statement assumes that all the subsidiary companies are of substantially the same relative importance to the system. An individual subsidiary which happens to be unprofitable may discontinue preferred dividends and even bond interest, while at the same time the earnings of the other subsidiaries may permit the parent company to continue its own interest and dividend payments. In such a case, which is somewhat exceptional, the unprofitable subsidiary's charges are not really senior to the parent company's securities.

"The holder of preferred shares of an important operating subsidiary has to all intents and purposes a claim which is as fixed and enforceable on the system's earnings as have the owners of the parent company's bonds. But if the parent company becomes insolvent, then the owners of the underlying preferred issues no longer occupy the strategic position of a bondholder, since they cannot compel the operating subsidiary to continue paying its preferred dividends." Ibid., p. 178.

¹⁶"Saltex Looms, Inc., 1st 6s, due 1954, were obligations of a subsidiary of Sidney Blumenthal & Co., Inc., but in no way guaranteed by the parent company. The consolidated earnings statements of Blumenthal regularly deducted the Saltex bond interest before showing the amount available for its own preferred stock. Interest on the bonds was defaulted, however, in 1939; and in 1940 the bonds sold at 7 while Blumenthal preferred was quoted above 70." Ibid., 233.

H Company and Subsidiaries
 Consolidated Income Statement
 For the Year Ended -

Revenues			
Sales of merchandise (to outsiders)		\$xx	
Interest earned (from outside sources)		xx	
Other revenue (outside)		<u>xx</u>	
Total revenues			\$xx
Expenses, losses, and taxes			
Expenses			
Merchandise cost of sales	\$xx		
Selling expense	xx		
Administrative expense	<u>xx</u>	\$xx	
		xx	
Losses			
Taxes			
Payroll taxes	\$xx		
Property taxes	xx		
Income taxes (see note on dividend taxes)	<u>xx</u>	<u>xx</u>	
Total expenses, losses, and taxes			<u>xx</u>
			\$xx
Net income to investors			
Assignable to subsidiary equities outstanding			
Interest charges on subsidiary debt (outside)		\$xx	
Assignable to subsidiary preferred stock (outside)		xx	
Assignable to subsidiary common stock (outside)		<u>xx</u>	
			<u>xx</u>
Net income to H Co. investors			
Interest charges on H Co. debt			<u>xx</u>
Net profit to H Co. stockholders			
Dividends declared on H Co. common stock			<u>xx</u>
Net addition to surpluses			
H Co. surplus (beginning of period)			xx
H Co. equity in subsidiary surplus (beginning of period)			xx
Total surplus (end of period)			<u>xx</u>
			<u>xx</u>
H Co. surplus (end of period)		\$xx	
H Co. equity in subsidiary surplus (end of period)		xx	
Total surplus (as above)		<u>xx</u>	

Schedule A
 Minority Interests in Surplus

	Preferred	Common
Surplus (beginning of period)	\$xx	\$xx
Net income for period assigned	<u>xx</u>	<u>xx</u>
	\$xx	\$xx
Dividends declared	xx	xx
Surplus (end of period)	<u>xx</u>	<u>xx</u>

dividend charges of the system. The only alternative would be to split up the net income according to the sources and show the deductions from the sources according to the order of precedence. When a number of different types of subsidiary shares in income are found, it will be necessary to rely upon the individual income statements of the subsidiaries to show the interest and dividend coverages. The above illustration shows a maximum of information for H Co. interests. It should be noted that the amount assignable to subsidiary preferred and common may be negative.

If realized intercompany profits are considered, a net adjustment may be inserted at the "net income to investors" level. It should be noted that the net includes all markups on goods sold this period but not on goods held in inventories.

Analysis of Consolidated Statements

It is sometimes suggested that the peculiar nature of consolidated statements makes them unsuitable for ratio analysis. A statement can give no information as a statement but only as the statement presents a picture of various relationships which may be best understood by comparing the figures; the denial of ratio analysis to consolidated statements would seem to excuse the accountant from the task of preparing consolidated statements. There can be no question, of course, that certain ratios are not suited to the analysis or are downright misleading when used. When consolidated statements are properly designed for particular purposes¹⁷ and the ratios capable of revealing the

¹⁷The first major point for consideration is, therefore, what are the major uses of financial accounts. We can recognize at least ten

relationships which the statements were designed to show are used, there should be some value in the resulting conclusions.¹⁸

Current Ratio

The ratio of current assets to current liabilities should probably not be applied to consolidated balance sheet without qualifications. An apparently adequate ratio can result from the combination of a weak situation with a strong situation failing to reveal the fact that the parent or some other key member of the system might be in current financial difficulties.¹⁹ It must also be remembered that different types of activities require different short-term financing depending

distinguishable uses:

1. As a report of stewardship;
2. As a basis for fiscal policy;
3. To determine the legality of dividends;
4. As guide to wise dividend action;
5. As a basis for the granting of credit;
6. As information for prospective investors in an enterprise;
7. As a guide to the value of investments already made;
8. As an aid to Government supervision;
9. As a basis for price or rate regulation;
10. As a basis for taxation."

G. O. May, Financial Accounting, p. 3, N. Y., 1943.

¹⁸"In general ratios should be computed only in terms of the reports of specific companies, and where it is deemed necessary to apply this line of interpretation to consolidated statements the results should be used with a full knowledge of their limited significance." Paton, op. cit., p. 753.

¹⁹"A particular case in point which demonstrates the wisdom of requiring both balance sheets is that of the Baldwin Locomotive Works. This company, in October, 1934, gave notice of its inability to meet the interest payments due November 1, 1934 on its First Mortgage Bonds of 1940. The reason for this action was the serious impairment of the working capital position of the issuing company. On examination, the Commission found that, prior to its annual report of the year ending in 1934, the company had published only a consolidated balance sheet and a consolidated profit and loss statement. No such statements were published for the parent company separately. The net quick asset position shown in the consolidated balance sheet was much better than that which would have been shown in the balance sheet of the issuing corporation. This was

upon purchasing, inventories, and receivables.

On the other hand, it would seem that there could be important efficiencies in well-planned intercompany financing. For example, idle cash resources could be pooled by delaying settlement of intercompany accounts or by advances, and invested in sound marketable securities. These pooled cash items would then be available to each member company in sound condition to enable it to meet its obligations promptly. This method would tend to reduce interest charges arising from short-term borrowing by member companies, increase interest revenue from short-term loans, insure that funds are available to all members to take discounts, and enable the members to make the maximum use of resources in periods when bank credit is in a disturbed condition. If this type of financial management is in use by a holding company system, the quick ratios of all member companies except the depository would appear at their minimum levels and even the current ratios may be affected if the parent is the depository and the funds are pooled by dividend disbursements or other long-term devices or if advances to and balances due from affiliated companies are excluded from current assets and amounts due to affiliates are excluded from current liabilities. It would seem that if there is free access by all members to current resources in the system the current ratio derived from the consolidated balance sheet is likely to give a better picture of the short-term financial strength than

due to the fact that the quick assets of one of the consolidated subsidiaries constituted a very substantial portion of the consolidated quick assets. If the balance sheet of the issuer had been published in addition to its consolidated balance, the intelligent investor would have been able to see the unsatisfactory working position of the issuer and would have guided himself accordingly." B. B. Greidinger, Accounting Requirements of the Securities and Exchange Commission, p. 45, N. Y., 1940.

the individual statements.²⁰

The current ratios of the individual companies may be distorted if the members show both advances and amounts due to affiliated companies. This would tend to reduce the current ratios although the net working capital would be unaffected. Membership in a holding company system produces some distortions of the current picture which may need to be clarified by having recourse to an analysis of the current picture of the group.

It may reasonably be concluded that an extremely good or an extremely poor current position in the consolidated statements indicates short-term strength or weakness in the system.

Equity Ratios

The peculiar advantages of consolidated balance sheets lie primarily in the equity relationships. In parent-subsidary combinations, excepting those cases in which the parent holds all of the equities, there tends to be a pyramiding of control by the parent which may result in senior equities in the system of a larger proportion than in any individual company. An investment in the stock of a subsidiary is an

²⁰"The short-term creditors of a dominant company are apparently in the same position with respect to consolidated reports as the creditors and shareholders of subsidiaries. The liquid assets out of which they may look for payment, and, if need be, against which they may enforce payment through appropriate court action are those of the dominant company itself. A dominant company may itself possess and use the power to appropriate the liquid assets of subsidiaries through borrowings and dictated dividends but the short-term creditors have no legal right to insist that a dominant company 'milk' a subsidiary for their benefit. The claims run against a single legal entity, the parent; the parent's statements then are the ones to be obtained and analyzed." M. Moonitz, The Entity Theory of Consolidated Statements, p. 14, American Accounting Association, monograph no. 4, Chicago, 1944.

investment in the difference between the assets and the prior obligations, or more exactly an investment in the assets subject to the prior obligations. When this type of investment is extended through several successive subsidiary levels, the total of the obligations to which the assets are subject becomes substantial. If the parent company statement were relied upon to show the relation between the debt and the stock equity, the offsetting of liabilities resulting from the showing of the net investment effect would tend to produce a wider margin of stock equity than actually exists. Only the group picture can show the total of all claims that take precedence over the parent company stock equity to give a basis for determining the financial risk involved.

The ratio of the parent company stock equity to the total of the consolidated equities can be an instructive figure but it must be used judiciously. There are situations in which the ratio thus developed becomes an average of separable weak and strong positions, and a full evaluation of the strength would require reference to individual statements and to the organizational pattern. If the parent company is an operating company as well as a holding company or if the organization is made up of several independent subsidiary systems controlled by the parent, the equity ratio within the parent company with respect to its own assets or with respect to certain subsidiaries may indicate more strength than the ratio in the group statement. In situations of this sort a relatively large shrinkage in underlying values might be necessary to wipe out a seemingly narrow margin attributed to the parent stock equity in the group balance sheet. The ability of the parent to continue as a separate organization or to escape losses in subsidiaries that

exceed the residual values ascribed to the parent must be considered in any estimate of the ability of the parent company to withstand unfavorable business conditions.²¹

Creditors of the parent company should consider the equity ratios of the consolidated balance sheet. Repayment of debt must, of course, come directly from the parent company assets. In case of extreme necessity the holdings of subsidiary stocks could be disposed of to provide the repayment but an extreme necessity may materially affect the value of the securities. A narrow margin of stock equity in the group portrayal is generally an indication of a weak buffer for the creditors. Further study of the marketability of the shares held and the possibility of divorcing certain subsidiaries will help to determine the extent of the weakness.

In the assumed case of a significant minority interest, certain aspects of the equity ratio need to be modified. The minority interest will tend to add to the buffer and may add staying power to the parent company stock equity. Since the minority interest in common stocks of

²¹"The bonds of a subsidiary of a strong company are generally regarded as well protected, on the theory that the parent company will take care of all its constituents' obligations. This viewpoint is encouraged by the common method of setting up consolidated income accounts, under which all the subsidiary bond interest appears as a charge against all the combined earnings, ranking ahead of the parent company's preferred and common stocks. If, however, the parent concern is not contractually responsible for the subsidiary bonds, by guaranty or lease (or direct assumption), this form of statement may prove to be misleading. For if a particular subsidiary proves unprofitable, its bond interest may conceivably not be taken care of by the parent company, which may be willing to lose its investment in this part of its business and turn it over to the subsidiary's bondholders. Such a development is unusual, but the possibility thereof was forcibly demonstrated in 1932-1933 by the history of United Drug Company 5s, due 1953." Graham and Dodd, op. cit., p. 232.

subsidiaries must share in value shrinkages and operating losses, the amount of subsidiary losses required to wipe out the value of the parent company's holdings would be correspondingly larger. For example, a subsidiary which has no debt but does have a substantial minority interest in common stock would be unlikely to suffer losses sufficient to reduce the value of the subsidiary's shares to zero. It is true that the losses would curtail or eliminate dividends of the subsidiary and make the discharge of the fixed interest commitments of the parent company less certain, but if the underlying values are not subject to extreme shrinkage, there will be some security of principal for the creditors and a residue of value for the stockholders of the parent. This safeguard may be investigated by calculating the ratio of total stock equity to the total of all equities in the group and by comparing this figure to the parent company stock equity related to the same total. The relation of the minority to the subsidiaries should also be discovered in the individual statements (a further reason for setting out the minority interest in the individual statements accompanying the consolidated statements). It may happen that the minority is not located in the subsidiaries most likely to suffer losses or that the minority is not large enough in the group picture to have a significant dampening effect.

Operating Ratios

The ratio of the total operating charges to total revenue derived from the consolidated income statement may be helpful in studying the profitability of the system. A vertical integration will produce an operating ratio different from the individual company ratios and there

may be no similar firm to serve as a basis of comparison, but the ratio may give a valuable insight into the characteristics of the trading margin. A series of these ratios through a business cycle will help to show the ability of the system to maintain revenues or to reduce costs to match declining revenues - the ability to avoid losses on an over-all basis and make enough profits to justify the existence of the system. The operating ratio for a horizontal system, however, will be a weighted average of the individual companies on the same level of activity. Valuable information can be obtained by plotting this ratio over a cycle together with the individual company ratios.²² The contribution of each subsidiary is thus set against the average and the stable and profitable elements can be sorted out. A general idea of operating relationships and the future course of the business can often be developed from this type of analysis.

Earnings Rates

An adequate return on resources employed is the goal of any sound business management and can be used as the primary aim of an investor. The ratio of "net income to investors" to total assets employed (ideally this should be adjusted for implicit interest on current debt) compared with similar business enterprises or with other operating periods will indicate the relative efficiencies of operations and the profitability of investments. When this ratio is applied to consolidated

²²"An additional limitation (of ratio analysis) relates to the analysis of consolidated statements. Since consolidated data are derived from the statements of two or more individual enterprises, ratios based thereon are in effect averages, weighted averages; they do not express a condition or relation with respect to any one company." W. A. Paton, Accountants' Handbook, p. 76, N. Y., 1943.

statements, the average efficiency in the use of resources is pictured. Because the efficiencies may vary between subsidiaries and the minorities may also vary, the rate must not be taken to apply to the parent company interests.

To arrive at the value of an investment in the stock equities of the group, the analyst would relate "net profit to stockholders" to the total stock equity. This will give the total rate on all stock equities including the minority interest. The minority participates in a limited sense only and the inclusion of the minority will tend to distort the information for parent company purposes. Net profit on parent company stock equity to parent company stock equity will be a better indication of the profitability for parent company investors. By comparing this rate with the rate derived from the parent company statements in which the investment aspects of the holdings are stressed, the investor can more readily see the relation between irregular subsidiary dividends in the immediate picture and the underlying earnings that form the ultimate basis for the parent company earnings rate. The effect of the minority upon the majority is partially revealed by comparing the rate on all stock equity with the rate on parent company stock equity, but an interest rate on parent company debt that differs from the earnings rate will tend to affect the comparison.

Minor Ratios

There are an endless number of comparisons that might be made of figures appearing on the statements. It is questionable procedure to carry the construction of ratios on consolidated statements to the

more technical relationships, but some of the turnover rates may be useful in certain cases. Obviously the receivables turnover rate for a vertical organization will be the rate of the last company handling the goods; for other types this turnover rate is an average which may measure the working capital needs of the system and indicates how the working capital should be allocated. Turnover of inventories in a vertical system will be much slower than the turnover of any of the companies, will tend to be the sum of the turnover periods for the goods included in the product, and will indicate the working capital need of the system and the areas requiring the working capital. Inventory turnover for other types of systems will give the average waiting period for the group. Turnover rates of receivables and inventories computed on a monthly or weekly basis should aid in the budgeting of working capital.

Total revenue traced through for a number of years is very useful in the study of the growth of an enterprise and is more meaningful for some purposes when related to the amount of the resources employed. The ratio of revenue to resources gives an idea of use of available productive values. When this is compared with the rate of earnings on total assets, the behavior and effect of costs can be more clearly visualized. Long-run comparisons of this sort are probably the most valid and most useful relationships that can be developed from consolidated statements.

Risk Factors

Estimation of the general business risks will proceed in the same fashion as in the simple case but there must be an additional

estimate for the system as a whole tempered by the effects of a partial dissolution of the system. Financial risks in a holding company organization vary somewhat and may require special analysis. The debt of any holding company may be in a secondary position to the debt and even the preferred stocks of the subsidiaries with respect to the assets of the subsidiaries. To determine the security of the principal two courses are possible and probably both should be used. The assets of the holding company should be studied. The investments in subsidiaries will be valued in terms of the potential disposal values in emergencies and the stock equity buffer of the holding company must be examined to discover if it will cover the potential losses. The consolidated statements will supply some direct information concerning the order of loss bearing and will emphasize the position of the parent company stock equity. A relatively small stock equity will indicate that material losses will jeopardize the position of the creditors.

The security of the interest will be affected by the interest coverage as evidenced by the "net income to investors" of the parent company on the consolidated income statement as compared to the interest charges of the parent company,²³ but it must be remembered that the portion earned by subsidiaries must be made available by the subsidiary through dividend declarations before the proceeds can be

²³"The interest coverage shown by the income account of the parent company only is an example of the prior deductions method, and consequently it will always make a better showing for the parent company's bonds (as a ratio) than will be found in the consolidated report. The investor should pay no attention to the 'parent company only' figures and insist upon a completely consolidated income account." Graham and Dodd, op. cit., p. 177.

used to pay interest. Non-fund charges are often considered as an adjustment of earnings to arrive at the amount of current operating proceeds available in periods of short-term difficulties to meet interest requirements. If depreciation and other items of this type are added back to consolidated net income, an exaggerated amount of available proceeds may result. Dividends of subsidiaries will be based upon earnings and available funds and dividends are not likely to be continued in periods of losses to any great extent even if previous surplus balances exist and current resources are made available through recovery of costs of plant. It is very dubious procedure to consider non-fund costs as adjustments to a greater amount than the non-fund costs of the parent company.

Holding company situations also place a new construction upon the profitability of trading on the equity. Trading on the equity is somewhat disguised in the individual company statements and does not have the same effect when the debt is outside the parent company. It is possible to trade on the equity in certain areas and not in other areas. Thus the total effect may be to gamble with certain assets but restrict the losses to those assets. System-wide trading on the equity may also be accomplished by issuing prior claims on the parent company. It should be understood that a minority interest in common stock does not constitute trading on the equity since the minority share of earnings is not a fixed rate. The minority helps to bear the brunt of trading on the equity and to that extent makes trading on the equity less dangerous. The profitability of arranging the financial structures to include debt and preferred stocks will depend upon where

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the debt and preferred stocks are located and the rate and stability of earnings of the firm affected. Although the holding company system may have more stability than any of its parts, it is more likely that the system will tend to show greater proportional income fluctuations than any of its parts, being the sum of harmonious fluctuations. The advisability of issuing debt or preferred stock by the parent will be conditioned by the stability of earnings and the likelihood of the earnings and retirement resources being available at the times required.

Dividend Policy

Dividends are appropriations of the earnings of the declaring company. The earnings of a holding company that form the basis of dividends must come at least partially from the distributed earnings of the subsidiaries. It is the earnings of the subsidiaries that underlie the dividends of the parent in spite of the fact that the earnings must be transferred before they may be appropriated by the parent. There is a possibility that this intermediate step may tend to delay the final appropriation of earnings for parent company dividends, but there is no apparent reason for assuming that this delay would be material in normal times. When the proceeds of earnings of subsidiaries are available for distribution, the declaration of dividends by the parent can be made coincident with the declarations by the subsidiaries. Effective control of the subsidiaries would tend to make the dividend programs of the subsidiaries and the parent fit together. Nor is there any real justification in supposing that the parent-subsidiary device would require larger retentions of earnings than a comparable single firm. Actually there are dangers in basing

dividends on the earnings of the parent company or in relying upon the parent company reports to indicate the dividend potentials. If investments in subsidiaries are kept at cost by the parent, dividends received from profitable subsidiaries appear as earnings of the parent, but these earnings are not offset by the losses of other subsidiaries. Legal surplus could exist in the parent and dividends could be continued when the system as a whole is losing substantial amounts. Unless the system undergoes reorganization and the unprofitable subsidiaries are dropped, dividends of this sort may amount to concealed liquidating distributions.

Consolidated income statements should provide the information for estimates of the dividend potentials of the parent company, but the consolidated balance sheet will be of little value in determining the policy with respect to maintaining dividends. Future dividends can be assumed to correspond to the capacity of the system to earn. Some adjustment of the capacity may be made by considering the capacities of the member companies and the possibilities of abandoning or improving the weaker members. Normally the policy of declaring moderate dividends in periods of prosperity with the intention of continuing the dividend through periods of depression can be detected by tracing the growth of surplus and current resources or investments.²⁴

²⁴Consolidated statements alone cannot be used as a basis for formulating or anticipating dividend policy, unless they are prepared with this end explicitly in view. The dividend policy of the parent company will depend on the composition of its own surplus account, the form in which its assets appear, the corporation laws of the state in which it is incorporated, and its future financial needs and prospects. The dividend policy of its subsidiaries will depend upon similar considerations. Consequently the existence of a large consolidated surplus account or a strong consolidated working capital position is no assurance

In the consolidation situation, however, surplus is constructed to show the growth of the stock equities from retained earnings rather than the amount of legally available surplus. Some of the surplus growth may have developed in the consolidated balance sheet from the recovery of acquisition date deficits. Surplus capitalized in the subsidiary by stock dividend declaration may have been restored to earned surplus in the consolidation. Sinking fund reservations are always difficult to construct properly whenever the reservations start before acquisition. Possibly the nature of the consolidated surpluses could be indicated by means of reserves and footnotes but there are modifications which are almost impossible to weave into the picture. It is safe to conclude that the investor should refer to the individual statements to construct the dividend policies of the management of a holding company system.

Excluded Subsidiaries

Analysis of consolidated statements will need to be modified whenever there are subsidiary companies which are not fully combined as to the assets and debts and the revenues and costs. Studies of such statements are partial studies and must be extended to include an analysis of the excluded subsidiaries. An investor in the parent company is concerned with the whole system and may receive a better picture if the consolidated statements embrace the whole system to the extent that such inclusion is not misleading.

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Part of the analysis of consolidated statements which report some subsidiaries in one figure in the balance sheet and a net income figure in the income statement will proceed as if the consolidated statements were parent company statements. A separate construction of the effect of the debt structure and asset structure must be made in order to evaluate the characteristics of the net value included. The stability of the income picture can only be understood in terms of revenues and revenue charges. If the net income is included in consolidation rather than the dividends received from the subsidiary, the earnings rate on parent company stock equity may have some validity.

Comparative Statements

Ratios constructed from single sets of consolidated statements must always be properly qualified before their meanings may be determined. Series of ratios over periods of times generally are less subject to amendment, for the change rather than the amount receives the emphasis. In some respects the most fruitful source of information about a holding company organization is the comparative statement. Growth of the system and its facilities, improvements in financial structures, earnings tendencies, and many other vital aspects can be rapidly grasped by scanning the data.²⁵ Some difficulty may develop in interpreting the data when new subsidiaries are added or old subsidiaries are dropped

²⁵"In the general case in which special provisions giving them a lien on subsidiaries' assets are absent, long-term creditors of the dominant company may obtain some useful information from consolidated reports concerning the probable future trend of dominant company assets, although indications of this nature will be highly tentative." Moonitz, op. cit., p. 15.

during the time interval covered.²⁶ The analyst should also be careful to investigate changes in the subsidiaries in order to discover the location of the changes in the general picture.

Statements of funds based upon consolidated statements may facilitate the studies of comparative statements. Funds tend to move within the individual corporate compartments, however, and individual statements should be carefully examined to discover the allocations to particular uses.

Factors Affecting Comparability

There are several factors which tend to distort the relationships commonly relied upon to reveal the financial condition and profitability of a business organization:²⁷

1. Operating periods of the member companies sometimes vary by several months. The earnings of the system are not accurately revealed unless there is reporting of an exact period.

2. The addition or subtraction of a subsidiary during a period

²⁶"Consistency in consolidation is much to be desired in order that the maximum value may be obtained from comparisons of statements of successive years. New additions and omissions, if any, of consolidating units should be noted on published statements, and their general effect on the total indicated." E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," The Accounting Review, XIII, 65, March 1938.

²⁷"Another important limitation of consolidated statements has to do with subjecting them to statistical analysis. In the first place, the underlying individual figures may not be comparable. If they are, the following conditions must have been met:

1. The combining statements must be approximately of even date.
 2. The various companies should be engaged in similar or related lines of business.
 3. Valuation bases of the assets combined must be the same.
 4. Accounting methods of the companies consolidated must be uniform, and their business policies should be substantially the same."
- Daniels, op. cit., p. 84.

does not show the operating conditions of the whole period and cannot relate the earnings to the assets employed for the period.

3. Changes in the percentages of control of a substantial amount have much the same effect as changes in the member companies.

4. Expansion of certain areas are considerably diluted in the consolidated statements.

5. The consolidation may overlap several industries which require different asset structures and justify different equity arrangements.

6. The system may be a unique combination of activities for which no standards of comparison may be available.

7. Differences in size may result in the combination of large-scale with small-scale activities.

8. Accounting procedures may vary. One member may use first-in-first-out while another uses last-in-first-out.

9. Different control percentages would involve differences in the relationships between equities and assets.

These and other factors tend to reduce the effectiveness of the consolidated statements. In many cases the distortions may be insignificant but the distortions must always be considered.

Summary

The accountant is confronted with two problems in dealing with a holding company system. The reality of the individual corporations cannot be denied but neither can the economic reality of the association be overlooked. A question develops as to how to show the whole and the component parts at the same time. Probably most simple holding company systems could be reported by means of consolidated statements properly

annotated, but the individual company reports are basic from the legal standpoint, and confusion of the contractual provisions may result if the legal statements are omitted. No simple reporting techniques have yet been or are likely to be developed to present the financial conditions and operating activities of a holding company and its subsidiaries. The situation is complex; the analysis of the situation must be complex.

By insisting that individual statements of all subsidiaries in which there is a significant outside interest be included with consolidated statements, the accountant is free to construct the consolidated statements to represent the over-all picture. These statements should follow the same general pattern and serve to point out the same relationships for the total as the individual statements do for the individual companies. If the consolidated statements are prepared with the limitations of the statements clearly in mind, and the purposes for which the statements are prepared are carefully defined, a useful analysis should result. Some additional insight may be furnished the reader of consolidated statements by modifying the individual statements to show how the member companies fit together.

Consolidated statements show the holding company system as a whole, but it is seldom that an investor can be content to view the whole and ignore the parts. Ratios and comparative statements of the system are helpful in that they can be construed as weighted averages of the members against which the individual members can be examined. The various equity aspects of consolidated balance sheets and earnings related to equities are more than averages, and although these relationships cannot be trusted to reveal all essential information, they are of primary

importance to all investors in the parent company. No adequate concepts can be constructed of the relationships of parent company debt to stock equity from the individual statements without following the same procedures involved in preparing consolidated statements. It is particularly important for the investor or the analyst to understand the weaknesses and advantages of the consolidated reports, for although he cannot do without such reports, he may be tempted to place too much reliance upon them.

CHAPTER X

SUMMARY

The rapid expansion of the area and population of the United States has brought about a comparable expansion of the business enterprise. Tempted by the prospects of monopoly profits or the economies of large-scale activities business men developed new organizational devices to expand the enterprise. In most expansion cases adaptations of reports for the single business unit suffice to reveal the new conditions, but the introduction of ownership-control of one corporation by another has presented some new statement problems. Consolidated statements were developed to report for control through stock ownership before adequate attention had been paid to the problems and principles involved.

Although accountants have paused from time to time to re-examine the premises upon which consolidated statements are founded, there are evidences that the growth in the use of the statements has outrun the thinking on the subject. It is felt that a survey of the problems encountered in preparing such statements, devoting greater attention to minority interest and valuation aspects and carefully adhering to sound general principles, should be helpful in forming a more consistent groundwork.

In a holding company situation separate statements of the member companies cannot show many of the important interconnections, yet the legal relationships between the contracting parties make it impossible to dispense with the individual corporate statements. It appears

necessary, therefore, to prepare consolidated statements to supplement the individual statements.

Statements which show the combined financial conditions and activities of a group of related corporations can have meaning only if the data combined are accumulated in all sectors by the consistent application of sound general principles and if the combinative procedures harmonize with the data. In preparing the reports to stockholders care should be exercised to insure that financially important legal positions are displayed, that going-concern aspects of valuation are stressed, that there is full and fair disclosure of factual information, that the proper relationships between assets and equities are presented, and that the boundaries of the consolidation are inclusive enough to overcome the inadequacies of the individual statements.

In order to trace the ownership characteristics of the value of the parent company to the physical items supporting the ownership and to discover the profitability of the parent company ownership, it will be necessary to treat the parent and its subsidiaries as one compound corporation. This treatment may proceed on the assumption that the parent purchased the subsidiary for the amount contributed and admits the outside debts as prior claims.

The Minority Interest

The preparation of combined statements for a group in which the parent is not the sole holder of the residual shares of the subsidiaries cannot realistically proceed upon the assumption of a merger of the companies. Acquisition of a controlling interest does not, as a merger would, fix the amount of the claim of the other parties. It is

therefore necessary to study the minority interest to determine the amount and character of its claim.

There appear to be only three reasons for the existence of a significant minority interest: stockholders have refused to sell to the parent company; the parent chose not to buy out the minority for financial reasons; and a minority interest may be desired to give legal reality to the separation of the resources of the corporations.

The minority interest is a stock interest; accordingly the legal status of the minority will depend upon the effective rights of a minority stockholder. Any stockholder will participate in profits and the proceeds of liquidation in proportion to the number of shares he holds. Possession of voting stock gives the holder the right to vote in the election of the board of directors and to pass on changes in the bylaws and in the charter, but the usual one-vote-per-share contract will cause the vote of the minority to be ineffective in most cases.

A majority stock interest is in somewhat the same position as management; good faith and diligence are required of all who are placed in charge of properties belonging to others. Care should be exercised to place all transactions on an arm's-length basis and to insure sound management of subsidiaries. Legal actions are available to minority stockholders to restrain inimical actions by management or to ask damages. There seem to be indications that the threat of court action serves to prevent abuses rather than to compensate for losses. To a degree the existence of a minority may result in placing impediments in the way of efficient management of group resources.

Generally the parent company benefits most when the profits of its subsidiaries are at their highest levels. Although there are instances in which the final profits of the parent may be increased by diverting the revenues of a subsidiary or assessing extra costs, manipulations of a size to be worth-while would tend to be obvious and would be considered fraudulent by a court. The conflicts of interests in this case are little different from the conflicts among the various interests in a single company.

There are three different methods of handling the minority interest in preparing consolidated statements: the minority may be subtracted from the subsidiary assets and equities before the parent's interest is accumulated; the minority may be treated as holding a preferred claim; or the minority may be treated as an associated owner. Both the reasons for the existence of a minority and the rights of the minority stockholders make it apparent that the minority is in effect, as well as in fact, a stock equity.

Consolidated statements are prepared primarily for the parent company equity-holders. In a limited sense the minority may also find these statements interesting.

Security Cost and Book Value Differences

When a controlling interest in an existing corporation is purchased, it is unlikely that the price paid for the securities will coincide with the book value represented. Immediate and subsequent reporting of the consolidated aspects of the security cost require a break-down of the cost into the asset and equity components. Book value may be helpful in this task but book value and current value will be

dissimilar in many instances. It is generally unwise to infer, therefore, in the absence of conclusive evidence, that the difference between cost and book value constitutes a profit or loss to the parent company. Excess or deficient earning power will, of course, affect the price paid, and it will need to be included realistically in the combined statements. There seems to be some point to restating the subsidiary's accounts to correspond to the valuation used for consolidation.

Assignment of the security cost to the elements may well proceed from an audited appraisal of the inventoriable assets. From the appraisal figure a verified and revalued total of liabilities should be deducted. The parent company's proportion of stock equity applied to this difference will give the parent's interest in inventoriable items. The interest thus derived will be compared with the security cost to produce the amount paid for intangibles. An allocation of this intangible value to factors having definite and indefinite lives may be useful.

Unless security acquisition results from negotiations with a small number of stockholders, the purchase is apt to be spread over a lengthy time interval and the price paid for the shares will not be uniform. In some instances it may be possible to assume a median date and price, but in other cases it will be necessary to compute the cost of intangibles at individual purchase dates. If this last recourse is necessary, the audited appraised values of inventoriable assets at the date control is established will be carried to the consolidation, and appreciation or declination as well as a share of the interim profit

or loss of the subsidiary must be attributed to the earlier holdings.

Other problems often arise. Probably inventories held by the acquired company at acquisition should be appraised at current cost value regardless of whether the items were purchased from the parent company or from a competitor. A purchase of shares from the subsidiary company in the process of acquiring control may affect the underlying values for which the price was paid. Convertible bonds outstanding should be adjusted to the higher of market value or revised conversion value. Acquisition of control between statement dates will require special treatment in the income statement.

No attempt should be made to impute a total value for intangibles on the basis of the purchase price of the controlling element. Varying purchase prices cast doubt on the selection of the representative price and some of the excess may apply to the group rather than to the subsidiary. Inaccuracies in the appraisal of assets, errors in attributing value to the equities, and ignored gains or losses in the purchase price will all affect the amount assigned to intangibles. In the final analysis the investor must impute his own value to excess earning power based upon his own earnings requirements. On the other hand, the inventoriable assets should be completely revalued at the acquisition date for consolidated statement purposes in order to show the majority position, to place the majority and minority on a comparable basis, and to reflect values in a sensible manner.

Subsequent Accounting for Value Differences

The excess of acquisition cost over book value, whether recorded on the subsidiary's books or not, must be accounted for as

attaching to the individual accounting elements. Realization of an appraisal difference will necessitate a transfer from appreciation or declination surplus. The assignment of an excess cost will either be in total, if the element is disposed of, or piecemeal, if the element is used in operations. Amortization of an amount assignable to goodwill is somewhat controversial. In general, it appears to be unsound to continue to reflect the cost of an item when that item is gone even if it has been replaced by something similar.

A revaluation of either the security cost or the subsidiary book values after acquisition will disturb the relationship between the two. The extent and the nature of the revaluation will govern the statement portrayal. Any write-down in excess of consolidated earned surplus in this case would require that the future earned surplus be dated to indicate the point of origin.

Changes in stockholdings can have but two major effects. The total outstanding stock of the group or the relative holdings of the majority and minority may change. Since revaluation cannot be justified for every change in the parent's holdings, a comparison of the new majority and minority interests with the old interests and with the costs or proceeds produced by the change, if any, can be considered adjustments of intangible excesses, in the absence of specific information to the contrary.

Subsidiary Bonds

A purchase of common stock is a purchase of residual rights in earnings. The price paid for shares imputes a value to the difference between the assets and the prior claims. Full imputation of current

value to the assets from the value of the equity contracts must be based upon all of the equity contracts outstanding. Debt contracts are readily valued by capitalizing the promises at a proper effective interest rate.

If the parent company holds bonds of a subsidiary company, a gain or loss will be attributed to the parent company interests for the difference between the cost of the bonds to the parent and the revised value of the bonds adjusted to the date of purchase. By a proper treatment of the gain or loss (in the elimination process) the parent and subsidiary revised values as well as interest revenues and interest charges will correspond and may be eliminated in consolidation. Sale of subsidiary bonds by the parent amounts to a new issue of debt.

Subsidiary Preferred Stock

In a similar manner the current value of subsidiary preferred stock at the date control is acquired will influence the determination of the value to be attributed to the assets. A fully participating preferred should probably be treated in the same manner as common stock by valuing the preferred at the amount of the commitment plus the total rights of the preferred in earnings.

A parent company holding of subsidiary preferred stock must be adjusted to the revised total value (in the elimination process) by recognizing a gain or loss to the parent, if the preferred is non-participating, or by adjusting excess cost of intangibles, if the preferred is fully participating.

Intercompany Charges in Assets

The sale of property or services by one member of a group of

related companies to another member at a price that differs from the total cost to the seller results in the recognition of a profit or a loss which will not be realized by the group until the property or services have been utilized in making a sale to an outsider. Goods acquired from an affiliated company and still on hand should be valued at total cost including the original purchase price of materials and all assignable charges. Interest charges and income taxes may be prorated to goods on hand to give a better picture of the revenue relationships.

If either the selling or buying member includes a subsidiary minority interest, the markup difference is a component of realized revenue or of cost to the minority. The realized portion of a markup may be left in the equity element and the debit element may be separately displayed.

Markups differing from costs may apply to almost any type of asset. The elimination must follow through to the ultimate disposal to insure that costs are properly stated. Care should also be taken to reassign markup components according to the adopted income statement cost classification as the items are charged to operations.

Revenue and Surplus Problems

Elimination of intragroup activities to place the income statements on a group basis will affect the portrayal of operations, the assignment of earnings, and the analysis of surplus assignments. Consolidated income statements match costs and other charges incurred by the group against revenues derived from outside sources. Intercompany sales of goods or services must be offset against cost elements in such

a manner as to leave only the sales to outsiders and the actual costs assignable without duplication. It must be remembered, however, that the minority interest in a subsidiary will share in the earnings of its individual corporation before the elimination of intercompany transactions.

Different statement dates for member companies will be certain to cause distortion of the combined statements. Although such a difference cannot be condoned, there may be instances in which the results will be informative.

Dividends declared from profits earned since control was established on stock of a subsidiary held by a parent company must be eliminated in consolidation by offsetting the charge against the revenue, but the parent company surplus should receive the effect as a surplus transfer. Dividends assignable against profits of a subsidiary obtained before control was acquired should be treated as investment reductions and will not affect the consolidation.

Stock dividends may affect the cost assignment on the parent's books but will not materially change the elimination entries and will have little effect upon the consolidated statements. Surplus appropriated for such dividends will remain consolidated surplus although permanently capitalized.

Consolidated surplus should be designed to indicate the growth aspects and to give clues as to the dividend potentials. New stock issued by the subsidiary at a price exceeding stated value will usually shift the interest in earned surplus and capital surplus between the minority and the parent even though no gain or loss is involved.

Earnings which reduce a deficit at acquisition produce consolidated surplus but not legal surplus. Losses which reduce acquisition date surplus produce a consolidated deficit but legal surplus may still exist.

The minority interest should bear its share of losses. When this share of losses becomes great enough to produce a negative minority interest, a special study of the situation including the possibilities of recovering the losses or detaching the subsidiary will be necessary before deciding to offset the deficiency against the parent company stock equity.

Surplus reserves of a subsidiary tend to be eliminated or reduced in consolidation. Contractual reserves should be properly noted on the consolidated statements if they cannot be carried as reserves. Reserves may be set up on the consolidated balance sheet to indicate that income taxes on future dividends of the subsidiary will tend to reduce the amount of subsidiary earnings that could be distributed to the parent company.

Consolidation of a foreign subsidiary involves conversion of the foreign value elements into dollars and then the usual combination of like items. The accepted conversion procedures offset original dollar costs against current dollar values of revenue to obtain the profit on foreign operations. Fluctuations in the exchange rate may cause the surplus thus accumulated to differ from the current rate conversion of the book surplus. By this means gains or losses on exchange fluctuations are recognized when foreign currency (or foreign receivables) is acquired rather than as such currency is converted into dollars. The existence

of exchange restrictions and some other impediments may cast doubt upon the validity of this procedure and upon consolidation.

Investments of Subsidiary Companies

When the subsidiary holds enough stock in another company to be in turn classified as a parent company, the top parent controls the immediate subsidiary and through it the final subsidiary. Value revision will be advisable at the date each subsidiary is acquired or for both subsidiaries at the date of the acquisition of the subholding company if that date is more recent. Transactions in stocks or bonds will produce changes similar to those in the simple situation, but shifts in minority interests may be found on each level. In all of the analysis it must be remembered that the minority interest in the subholding company is an interest in a parent company.

Ownership of parent company shares or bonds by the subsidiary must be eliminated to show the total assets of the group and the total claims of outsiders. Elimination of participating ownership involves a circular calculation to determine the final assignment of the shares in earnings of the various classes of stockholders. A substantial holding of parent company stock may make revision of the parent company values desirable at the acquisition date of such stock or the acquisition of control of the subsidiary whichever is later. Elimination of intercompany markups in assets differing from costs in this situation will necessitate a closer scrutiny of realized gains or losses. Since each company participates in the earnings of the other, the minority's share of such gains or losses will be only partially realized in the intercompany sale. Parent company bonds held by a subsidiary should

be adjusted for consolidation purposes to the book value as carried by the parent. The difference, if any, will be treated as a gain or loss to the subsidiary.

The Statements

If individual statements are prepared for all companies having important outside equities, consolidated statements can be devoted to the problems of depicting the group position. Thus both the legal and economic positions can be clearly displayed. It is advisable to prepare these combined statements in good balance sheet and income statement form rather than as partial schedules. Given harmonious values the accountant must arrange the assets in a manner that will set forth functional relationships. Certain subsidiaries may need to be given special reporting attention to avoid confusion. Over-all aspects of the various equities may be stressed since it is not possible to show exact legal relationships between the assets and the claims. Individual statements which accompany the consolidated statements may well be designed to emphasize the relationships nowhere else displayed. Liberal references should be made to these statements to avoid misrepresenting the equity positions. The scope of the income statement should coincide with the scope of the balance sheet in all respects.

Most of the ratios derived from consolidated statements are weighted averages of the ratios of several companies and as such do not represent the conditions of any one company or any equity interest. On the other hand, ratios which bring out the relationships which the statements are designed to present should be useful. Earnings ratios and equity ratios should be particularly informative since these ratios

show relationships that cannot be derived from individual statements.

Analysis of consolidated statements is not a simple task.

There are numerous factors which tend to destroy the comparability of the items combined and which subject the portrayal to many qualifications. Holding company systems are complex arrangements in which the individual companies and the group of companies are both significant. Development of better reporting devices and improvements in methods of analysis will help to give a better insight into the facts, but truthful reporting will never give a concise and coherent picture of heterogeneous financial data.

APPENDIX

AN EXTENDED ILLUSTRATION OF THE USE OF APPRAISAL DATA IN CONSOLIDATION

Two simple examples have been given of the use of appraisal data in preparing consolidated balance sheets at the acquisition of control. The following illustration introduces some additional complications and attempts to follow through the steps in a more thorough manner.

On June 20, 1937, the Par Company, a manufacturer of a metal product, selling to the public through independent dealerships, acquired 10,000 shares, a 25% interest, of Sub Company, one of the subcontractors of Par Company, at a cost of \$126,430. This stock interest was sufficient to bring about close co-operation between the two companies, but Par Company found it advisable to secure an additional block of 20,000 shares on September 1, 1946, at a cost of \$333,720. No attempt was made to prepare consolidated reports during the period that an interest of less than control was held. With the acquisition of the second block, however, consolidated statements became essential. It now appears necessary to go back to the values existing in Sub Company on June 20, 1937, in order to determine the cost of goodwill in the first purchase. It is not possible as of September 1, 1946, to make an actual count of the properties on hand, but a fair approximation may be made. Fairly detailed balance sheets are available for December 31, 1936, and December 31, 1937. It is believed that the operations during 1937 were fairly smooth and that

corrections of the effects of fluctuations can be closely approximated. Averaging the two balance sheets will give a rough approximation of June 30, which is close enough to the acquisition date for all practical purposes. With a schedule of average figures as a guide (see accompanying figures), the items can be examined in detail.

Analysis of Sub Company Values as of
June 30, 1937

	Average of Dec. 31, 1936, and Dec. 31, 1937 Balances	Audited Appraised Values
Current assets		
Cash items	\$ 30,000	\$ 25,000(a)
Receivables (net)	60,000	56,000(b)
Interest accrued receivable	1,000	1,600(c)
Inventories	87,000	96,000(d)
Prepaid insurance	2,000	2,400(e)
Stock of Kensolite Co., (10% interest)	40,000	44,000(f)
Plant assets		
Land	50,000	60,000(g)
Building (net of depreciation)	120,000	150,000(h)
Equipment (net of depreciation)	170,000	180,000(i)
Patents (at cost net of amortization)	20,000	-
Goodwill (at cost unamortized)	10,000	-
	<u>\$590,000</u>	<u>\$615,000</u>
Current liabilities		
Accounts payable	\$ 40,000	\$ 43,000(j)
Notes payable	10,000	16,000(k)
Interest accrued payable	3,000	1,300(l)
Wages accrued payable	12,000	10,000(m)
Taxes accrued payable	7,000	3,100(n)
Convertible bonds payable, 5% due March 1, 1959, each \$1,000 face exchangeable for 60 shares of common stock (net of discount)	68,000	67,400(o)
Stock equity		
Common stock	400,000	-
Earned surplus	50,000	-
	<u>\$590,000</u>	<u>\$140,800</u>
		<u>\$474,200(p)</u>

(a) Actual cash on hand June 30 was ascertained by referring to the accounts as reconciled to the banks on that date.

(b) Analysis of the customers' ledger shows that \$56,700 was collected of the total accounts and notes outstanding June 30, but that \$700 was attributable to discounts lapsed after June 30.

(c) \$1,600 was the amount of interest accrued on interest bearing receivables on this date, subsequently collected in full.

(d) Examination of cost records and perpetual inventory records of materials shows \$98,000 of all classes of inventories. \$2,000 of this amount resulted from ignoring purchase discounts and from over-loading cost assignments.

(e) Examination of insurance records reveals that \$2,400 of costs apply to future periods.

(f) The market price of Kensolite stock was \$44,000 on June 30.

(g) A neighboring site sold in June of 1937 formed the basis for estimating a value of \$60,000 as the value of the land if cleared of all structures. The land was originally purchased in 1934, on a market clearly lower than 1937.

(h) The building constructed in the summer of 1934, at a cost of \$133,333, had an estimated life of 30 years with no scrap value expected. Building costs have increased 25% for this type of construction. The building is modern and as efficient as any of the later structures. The life expectancy has not changed.

(i) Current quotations on equipment were applied to the items revealed to be on hand by the plant ledger and due allowances were made for depreciation, obsolescence, and abandoned items to arrive at a figure of \$180,000 for the net value of all equipment.

(j) The creditors' ledger showed the net amount due to trade sources to be \$43,000.

(k) Notes payable stood at \$15,000 on June 30.

(l) Interest accrued on obligations outstanding amounted to \$1,300.

(m) Wages accrued were determined from the accounts.

(n) Taxes were computed by a partial reconstruction of the earnings picture for the half year and by recomputing property tax amounts.

(o) The \$600 correction of the bonds payable represents a revision of the discount accumulation schedule. The \$70,000 face value could have been exchanged at this time for 4200 shares with a total market value of \$53,100.60 as opposed to a total value as bonds of \$67,400, an obviously unprofitable conversion.

(p) The total value of the inventoriable assets minus the values assigned to the debt equals the tangible value of the total stock equity at June 30, 1937.

The net value of tangible items acquired by Par Company on June 30, 1937, was 25% of \$474,200 or \$118,550 for which it had paid \$126,430. The difference of \$7,880 can be considered the cost of intangibles to Par, \$380 more than recorded on the books. If the conventional reliance

upon the averaged figure had been used in this case, Par's share of the averaged stock equity would have been 25% of \$450,000 or \$112,500 and comparing this last figure with the cost would have yielded \$13,930 attributable to cost of intangibles in excess of those already recorded on the books, an obviously excessive amount in view of the increased property values and the errors of averaging.

At the acquisition of the second block of stock on September 1, 1946, Par comes into control and auditors and appraisers are sent in to examine the properties and records as of this date. The values in this case can be based upon physical examination and correspondence with debtors and creditors, but collection expectancy will be based on estimates rather than actual collections. The procedure follows the same pattern and is set up in a more condensed fashion in the accompanying schedule:

Analysis of Sub Company Values
as of September 1, 1946

	Post Closing Trial Balance Sept. 1	Audited Appraised Values
Current assets		
Cash items	\$ 50,000	\$ 50,000
Receivables (net)	80,000	81,000
Interest accrued receivable	2,000	2,000
Inventories	110,100	113,000
Prepaid insurance	3,000	3,000
Stock of Kensolite Co. (10% interest)	40,000	49,000
Plant assets		
Land	50,000	80,000
Building (net)	79,260	140,000
Equipment (net)	210,000	240,000
Patents (net)	25,000	-
Goodwill	10,000	-
	<u>\$659,360</u>	<u>\$758,000</u>

Analysis of Sub Company Values
as of September 1, 1946 (cont'd)

	Post Closing Trial Balance Sept. 1	Audited Appraised Values
Current liabilities		
Accounts payable	\$ 35,000	\$ 35,000
Notes payable	5,000	5,000
Interest accrued payable	2,060	2,060
Wages accrued payable	17,000	17,000
Taxes accrued payable	15,000	15,000
Convertible bonds payable	68,500	71,340
Stock equity		
Common stock	400,000	-
Earned Surplus	116,800	-
	<u>\$659,360</u>	<u>\$145,400</u>
Appraisal difference attributable to stock		<u>\$612,600</u>

As might be expected there is close agreement between the book figures and the audited figures in all items except plant. It was felt that the provision for doubtful accounts was over conservative and that the inventory values lagged slightly behind upward moving prices. With the common stock selling for \$16.98 per share the conversion value of the bonds exceeds the book value of the debt and conversion would have taken place except that the company has been retaining the major portion of its earnings with the result that the interest payments on the bonds still give a higher return than the dividend yield.

The rather complicated task of preparing the figures for consolidation is now in order. Par Company bought 20,000 shares, or 50% of the outstanding stock, for \$339,720 which is \$33,420 more than \$306,300-- its share of Sub's inventoriable assets minus debt. This \$33,420 is Par's cost of the intangible values for the last block of stock purchased. Of the cost of intangibles attributable to the first block

of stock purchased, some part must be assigned as a cost of the revenues attributed to the 25% investment. The patents valued at \$20,000 on the books of Sub June 30, 1937, have all expired or become obsolete and the cost of \$20,000 has been charged off against revenues. The characteristics of the operations are assumed to justify the valuation of \$24,000 for the patents in 1937, and the excess earning power has continued to improve in other respects since that date. The \$7,880 cost of the intangibles to Par can thus be divided, \$6,000 for patents and \$1,880 for continuing earning power. The \$6,000 must be considered a cost of dividends received from Sub and Par's interest in the retained earnings. The value of the patents owned in 1946 is estimated to be \$40,000; the engineers of Par Company indicate that the parent itself would be willing to pay this price. Value of a half interest, \$20,000, deducted from the \$33,420 leaves \$13,420 as the cost of Par's interest in other excess earning power factors, a total such interest of \$15,300, with the above \$1,880, to be reported as excess of cost over book value not attributable to patents or inventoriable assets. Of the 1946 recorded book values of patents, \$6,250 is applicable to the original investment.

The total ownership position may now be constructed. Par's interest in the total appraised value of the stock equity of \$612,600 is 75%, or \$459,450. If one adds to this last figure \$26,250 for the patents and \$15,300 for other intangibles the total to be portrayed as Par's interest is obtained, \$501,000. The total cost of the 75% interest amounts to \$466,150, which is \$34,850 less than the value

assigned to the interest for consolidation purposes. This latter difference is all assignable to the gains realized from holding the 25% interest,¹ in addition to any dividends that may have been received. The \$34,850 may be further broken down by investigating the share of earnings pertaining to Par. Surplus averaged on June 30, 1937 needs to be corrected by the amount of the discovered errors in current assets and liabilities, a net decrease of \$400, leaving a balance in surplus of \$49,600. The 25% interest in earnings can be discovered by comparing surplus June 30, 1937, with surplus September 1, 1946, a total difference of \$67,200, or \$16,800 as Par's share. This is not all clear to Par, however, for Par had a larger investment in plant in effect than did Sub. Building depreciation expense for Sub was \$40,740 but based on the higher cost to Par this item comes to \$50,925, a total difference of \$10,185, an increase of \$2,546 in operating costs. There will be a similar reduction in the earnings, of \$1,000, for the extra cost of the patents. It is not possible to compute an extra charge for equipment depreciation from the information given in view of the constantly changing items, but it would not be unreasonable to assume an extra charge of \$8,000, considering the short life of such items and that nine years have elapsed. This would

¹This may be easily demonstrated:

25% of appraised value	\$153,150
25% of patents cost	6,250
Remaining excess of original purchase	1,880
Total value of original purchase	<u>\$161,280</u>
Cost of original purchase	126,430
Increase over cost	<u><u>\$ 34,850</u></u>

mean an extra operating charge of \$2,000 for Par. Total extra operating charges now amount to \$5,546, leaving \$11,254 as Par's adjusted share of earnings. Of the balance of the \$34,850 gain in ownership from the 25% interest, \$23,596, is attributable to the appreciation of plant since 1937 (allowing for depreciation), to the increase in the value of Kensolite stock, to minor adjustments of receivables and inventories, and net of the increase in the carrying value of the convertible bonds.

If the above analysis be accepted, consolidation may now proceed without further difficulties with the difference between cost of securities and book value. The accompanying trial balance shows the values to be carried to the consolidation work sheet. The elimination will be made directly between the investment account on Par's books and the stock equity segregated as pertaining to the investment cost.

Sub Company Accounts to be Entered on Consolidating Work Sheet
September 1, 1946

Cash	\$ 50,000
Receivables (net)	81,000
Interest accrued receivable	2,000
Inventories	113,000
Prepaid insurance	3,000
Stock of Kensolite Co.	49,000
Land	80,000
Buildings (net)	140,000
Equipment (net)	240,000
Patents (book value)	25,000
Excess cost of patents to Par (20,000 - 12,500)	7,500
Goodwill (minority interest only)	2,500
Excess cost over book values not attributable to other items (consolidated goodwill)	15,300
	<u>\$808,300</u>

Sub Company Accounts to be Entered on Consolidating Work Sheet
September 1, 1946 (cont'd)

Accounts payable	\$ 35,000
Notes payable	5,000
Interest payable	2,060
Wages accrued payable	17,000
Taxes accrued payable	15,000
Convertible bonds payable	71,340
Minority interest in common stock (25%)	100,000
Minority interest in earned surplus (25%)	29,200
Minority share of appreciation in value of inventoriable assets	32,700
Consolidated earned surplus	11,254
Consolidated appreciation	23,596
Equity attributable to Par Company's investment	466,150
	<u>\$808,300</u>

Summary of Computations

Excess cost over book value attributable to patents	\$20,000
.50 x 40,000 the assumed value of the patents	12,500
Patent cost per books 50%	<u>\$ 7,500</u>
Excess cost of patents	

Excess cost over book value not attributable to other items		
Excess cost 1937		
Security cost	\$126,430	
Appraisal .25 x 474,200	118,550	
Total excess	<u>\$ 7,880</u>	
Attributable to patents amortized .25 x 24,000	6,000	\$ 1,880
Excess cost of 1937 carried to 1946		
Excess cost of 1946		
Security cost	\$339,720	
Appraisal .50 x 612,600	306,300	
Total excess 1946 purchase	<u>\$ 33,420</u>	
Attributable to patents .50 x 40,000	20,000	13,420
Excess cost of 1947 not in other items		<u>\$15,300</u>
Total excess cost not reported elsewhere		

Net values 1946	Majority	Minority	Total
Inventoriable assets	\$568,500	\$189,500	\$758,000
Recorded patent value	18,750	6,250	25,000
Excess patent cost	7,500		7,500
Recorded goodwill	7,500	2,500	10,000
Excess costs (15,300 - 7,500)	7,800		7,800
Total assets	<u>\$610,050</u>	<u>\$198,250</u>	<u>\$808,300</u>
Debt	109,050	36,350	145,400
Net values	<u>\$501,000</u>	<u>\$161,900</u>	<u>\$662,900</u>

Minority components				
Total net value of stock equity				\$161,900
Common stock 25%		\$100,000		
Earned surplus 25%		<u>29,200</u>		<u>129,200</u>
Minority interest in appreciation				<u>\$ 32,700</u>
Majority components				
Total net value of stock equity				\$501,000
Outlay for securities \$126,430 and \$339,720				<u>466,150</u>
Majority gain on a 25% interest				\$ 34,850
Attributable to earnings:				
Surplus 1946 25%			\$ 29,200	
Averaged surplus 1937 100%	\$50,000			
Net corrections of current assets	<u>1,000</u>			
	\$51,000			
Net corrections of debt	<u>1,400</u>			
Corrected surplus 1937	\$49,600			
25% of corrected surplus 1937			<u>12,400</u>	
Unadjusted majority interest in profits			\$ 16,800	
Corrections of costs				
Extra cost of patent amortization				
6,000 - 5,000	1,000			
Extra building depreciation				
.25 x (50,925 - 40,740)	2,546			
Assumed increase in equipment deprec.				
.25 x 8,000	<u>2,000</u>		<u>5,546</u>	
Majority interest in profits, adjusted				<u>11,254</u>
Majority share of appreciation				<u>\$ 23,596</u>

Even this simplified case is rather involved. One can sympathize with those accountants who advocate the carrying of the subsidiary book values without attempting to analyze the components of excess cost. The procedure outlined and illustrated will give intelligible results if the audited and appraised values are good approximations. No attempt was made to go into the details of appraising property and earning power, for even a summary of the problems and procedures would necessitate a very considerable extension of the study.

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