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Surplus at date of acquisition; Introduction; Article no. 1; Article no. 2; Article no. 3

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Surplus at Date of Acquisition

Introduction

THREE very interesting articles on this subject have been written by members of the organization. The articles are reproduced herewith. Each author deals with the subject differently, and together the articles bring out practically all of the various aspects of the subject.

It is not the intention to discuss the subject here in a way that will detract from the dissertations themselves but rather to state the principal situations which give rise to controversy. They are as follows:

(a) Where the cost to the holding company is equal to the par value, or stated value, of the capital stock and surplus of the subsidiary company, and the balance sheets of the two companies are to be consolidated; shall the excess of cost over par be eliminated against surplus, or may the excess be shown as an asset, and the surplus be allowed to remain as such in the consolidated balance sheet?

(b) Where the cost to the holding company is in excess of the aggregate of par, or stated value, and surplus of the subsidiary; shall the excess of cost over par be shown as an impairment of capital, or eliminated against the surplus of any other companies in the consolidation, or may the excess be shown as an asset, described as what it is, or described as goodwill?

(c) Where the cost to the holding company is less than the aggregate of par, or stated value, and surplus of the subsidiary; may the excess be permitted to stand in the consolidated balance sheet as surplus available for dividend declarations, or must the excess be shown as capital surplus?

ARTICLE No. 1

By R. A. GALLAGHER, Chicago Office

The subject of surplus at date of acquisition is incidental to the subject of consolidated balance sheets. The purpose of a consolidated balance sheet is to show the position of the holding company in its relation to the general public, which is brought about by substituting the assets and liabilities of the subsidiary company for the investment in the capital stock of that subsidiary company

Each item appearing in a consolidated balance sheet should be shown in a manner which will portray that item in its true relation to the general public. Accordingly, in giving consideration to surplus at date of acquisition, we must keep in mind that the general public is especially interested in knowing the amount of surplus which is available for dividends, or which may legally become available for dividends. The following case has been constructed to give consideration, in the preparation of a consolidated balance sheet, to the two following described methods of showing the surplus at date of acquisition:

Method 1—Elimination of Surplus at Date of Acquisition.

Method 2—Showing the Combined Surplus Accounts without Elimination of the Surplus at Date of Acquisition.

Briefly, Method 1 contemplates the elimination of the amount of surplus of the subsidiary company at date of acquisition, so that surplus shown in the consolidated balance sheet would include, as to the subsidiary, only the undistributed earnings accrued since the date of acquisition of that subsidiary; whereas, Method 2 contemplates showing the combined surplus accounts of the subsidiary and holding companies, without regard to the time when the surplus accrued. The generally accepted method is Method 1. However, it has been contended by certain holding companies that Method 2 is preferable.

For the purposes of the case, let us assume that the balance sheets of the holding company and the subsidiary company, immediately after the acquisition by the holding company of the entire capital stock of that subsidiary company at December 31, 1917, are as follows:

	Holding Company	*Subsidiary Company*
Property	....	$100,000.00
Investment in capital stock of subsidiary company	$150,000.00	....
Current assets	....	100,000.00
Total	$150,000.00	$200,000.00
Capital stock	$150,000.00	$100,000.00
Current liabilities	....	50,000.00
Profit and loss surplus	....	50,000.00
Total	$150,000.00	$200,000.00

The consolidated balance sheets prepared under each method, are as follows:

A Holding Company

and Subsidiary Company

Consolidated Balance Sheet, December 31, 1917

	Method 1	*Method 2*
Property	$100,000.00	$100,000.00
Current assets	100,000.00	100,000.00
Excess of cost over par value of stock of subsidiary company	....	50,000.00
Total	$200,000.00	$250,000.00
Capital stock	$150,000.00	$150,000.00
Current liabilities	50,000.00	50,000.00
Profit and loss surplus of subsidiary company at date of acquisition	....	50,000.00
Total	$200,000.00	$250,000.00

It appears that (based on cases cited in "Profits, Dividends and the Law," by Reiter) a corporation should be possessed of property exceeding its liabilities and its capital stock before it may legally pay a dividend. At this point, therefore, it does not appear material that the subsidiary company may properly pay a dividend of $50,000.00 to the holding company, because, should the holding company pass this dividend on to its stockholders, the assets of the holding company (being represented entirely by the net assets of the subsidiary company) would be reduced to $100,000.00, while the capital stock outstanding would still be $150,000.00. The inclusion of an item—excess of cost over par value of stock of subsidiary company—does not in itself create value.

Based on the foregoing, it might be concluded that, inasmuch as the dividend paid by the subsidiary company to the holding company could not be passed on to the stockholders of the holding company, it would be misleading to publish the balance sheet as shown in Method 2. However, it would be well to consider whether or not the amount might become available at some future time.

Let us further assume that several years have elapsed; that the subsidiary company has written up its books to the present value of its property; and, that the balance sheets of the holding company and subsidiary company at December 31, 1927. are as follows:

	Holding Company	*Subsidiary Company*
Property—sound value, as at December 31, 1927, as appraised by	....	$150,000.00
Investment in capital stock of subsidiary company	$150,000.00	....
Current assets	....	150,000.00
Total	$150,000.00	$300,000.00

	Holding Company	*Subsidiary Company*
Capital stock	$150,000.00	$100,000.00
First Mortgage, 5% bonds, due 1945	....	50,000.00
Current liabilities	....	50,000.00
Surplus:		
Profit and loss	....	50,000.00
Arising from revaluation of property	....	50,000.00
Total	$150,000.00	$300,000.00

The consolidated balance sheets prepared under each method, are as follows:

A Holding Company
and Subsidiary Company

Consolidated Balance Sheet, December 31, 1927

	Method 1	*Method 2*
Property—sound value, as at December 31, 1927, as appraised by	$150,000.00	$150,000.00
Current assets	150,000.00	150,000.00
Excess of cost over par value of stock of subsidiary company	....	50,000.00
Total	$300,000.00	$350,000.00
Capital stock	$150,000.00	$150,000.00
First Mortgage, 5% bonds, due 1945	50,000.00	50,000.00
Current liabilities	50,000.00	50,000.00
Surplus:		
Arising from revaluation of property	50,000.00	50,000.00
Profit and loss, of subsidiary at date of acquisition	....	50,000.00
Total	$300,000.00	$350,000.00

Let us now assume that the subsidiary company paid a dividend to the holding company which credited the amount to suplus. The balance sheets immediately thereafter would be as follows:

	Holding Company	*Subsidiary Company*
Property—sound value, as at December 31, 1927, as appraised by	....	$150,000.00
Investment in capital stock of subsidiary company	$150,000.00	....
Current assets	50,000.00	100,000.00
Total	$200,000.00	$250,000.00
Capital stock	$150,000.00	$100,000.00
First Mortgage, 5% bonds, due 1945	....	50,000.00
Current liabilities	....	50,000.00
Surplus:		
Dividend received from subsidiary company	50,000.00	....
Arising from revaluation of property	....	50,000.00
Total	$200,000.00	$250,000.00

The subsidiary company, having a profit and loss surplus, has an unquestioned right to pay a dividend of $50,000.00 to the holding company. Also, the holding company has a legal right to consider the dividend received as income. As the holding company is now possessed of assets of a value which exceeds its liabilities and capital stock, in the amount of $50,000.00, there is considerable reason to believe that it would be justified in distributing its surplus in the form of dividends.

While considering the question of whether or not the surplus of a subsidiary company at date of acquisition by the holding company might be available for dividends to the stockholders of the holding company, it should be noted that the laws of the State of Delaware permit a corporation to issue its no-par-value stock at a stated value and credit any value received in excess thereof to surplus account, available for immediate distribution to its stockholders. Therefore, a holding company organized under the laws of the State of Delaware could retain the surplus at date of acquisition of any subsidiary acquired for immediate distribution to its stockholders, by issuing a no-par-value stock at a stated value equal to the par value of the capital stock of the subsidiary company being acquired, and crediting the surplus at date of acquisition of the subsidiary company to paid-in surplus.

ARTICLE No. 2

By H. W. Goodson, Dallas Office

The subject of this paper is a phrase used almost exclusively by accountants and by them only in connection with consolidated reports on subsidiary companies and their parent companies. This discussion of the subject, therefore, deals with the nature, from the standpoint of a parent company, of the surplus of a subsidiary company at the date its stock is acquired and the treatment of that surplus in the preparation of consolidated balance sheets.

The equity of a common stockholder in the net assets of a corporation is proportionate to his stock ownership. And since the value of the net assets of a corporation is theoretically, at least, equal to the aggregate of the capital stock and surplus, it follows that a stockholder owns the same proportion of the surplus as he does of the capital stock. For example, if a stockholder owns $1,000.00 par value of the capital stock of a company which has $10,000.00 capital stock, $5,000.00 surplus, and $15,000.00 net assets, he has an equity of $1,500.00 in those assets represented by $1,000.00 capital stock and $500.00 surplus.

If the stockholder acquired his stock at the date of incorporation or at some later date when the company had no surplus, the proportionate part of the surplus at any subsequent date pertaining to his stock represents the earnings on his investment, assuming that no dividends have been declared in the meantime. If, on the other hand, the company had a surplus when the stock was acquired, the proportionate part of that surplus which pertains to the stock acquired is a portion of the equity, purchased by the stockholder, in the net assets of the company. In that case, the stockholder's equity in the surplus at a subsequent date does not represent his earnings on his investment. It includes the earnings but it includes also that part of the surplus which together with the capital stock acquired represents the equity purchased by the stockholder, again assuming that no dividends have been declared. In other words, the earnings on the stockholder's investment would be represented by his proportionate part of the surplus at a subsequent date less his proportionate part of the surplus at the date the stock was acquired.

The principles stated above apply to all percentages of stock ownership and supply the reasons for the elimination in the preparation of a consolidated balance sheet of the surplus of a subsidiary company at the date of acquisition of its stock by the parent company.

The best accounting practice requires that such elimination be made in the preparation of consolidated reports of a parent company and its subsidiary company or companies. This is accomplished by substituting the net assets (assets less liabilities, exclusive of capital stock and surplus) of the subsidiary company at the date of acquisition of its stock for the cost of such stock carried on the books of the parent company. The cost of the subsidiary company's stock will rarely be the same as the aggregate of its capital stock and surplus at the date of acquisition, which is eliminated. The difference is shown as a separate item on the balance sheet. If the cost is greater it is shown as "good-will" or some other appropriate caption; if less, it is usually shown as capital surplus.

No difficulties are encountered provided all of the capital stock of the subsidiary is acquired at the same time and provided the correct surplus at that date is known.

If only a part of the stock is acquired, only the portion of the surplus attributable to the stock acquired should be considered in the elimination procedure outlined above. The remainder must be shown as applicable to the stock in the hands of outside interests. If some of the stock is acquired at one date and some at another, that fact must be taken into consideration in calculating the surplus at date of acquisition. If it is impracticable to determine the surplus at date of acquisition, the surplus at some other date as near thereto as possible may be used, unless the intervening time is so long that material changes would probably have occurred.

Dividends declared by the subsidiary company out of the surplus at date of acquisition should be credited by the parent company to its investment in the stock of the subsidiary, because such dividends represent a recovery of a part of the expenditures for net assets of the subsidiary company. Those net assets are reduced in the amount of the dividends by a transfer to the parent company, which has gained nothing. On the other hand, dividends declared by the subsidiary company out of subsequent net income should be credited to income by the parent company for the reason that an earning on its investment is thus reduced to possession. It would still have the original equity purchased and would have received something in addition.

Such treatment is necessary in order that the parent company's records may reflect the true conditions, but for the purposes of a consolidated balance sheet it is immaterial whether the dividends, to the extent of the surplus at the date of acquisition, have been credited by the parent company to investment or to income. The amount of the surplus of the subsidiary at date of acquisition should be eliminated regardless of the fact that by reason of a dividend's having been declared, it might appear in the surplus account of the parent company at the date of the balance sheet. If the parent company credits the dividend to investment the surplus at date of acquisition is thereby eliminated.

The end sought in eliminating the surplus of the subsidiary company at date of acquisition is not merely to follow an established accounting rule but to show as surplus only the undistributed net income of the consolidated group. An example from experience illustrates the point. A holding company purchased all of the common capital stock of an operating company which had a surplus at date of acquisition of $50,000.00. During the first year the acquired company earned $25,000.00 but needed more capital to extend its business. The additional capital was obtained by selling $50,000.00 in common stock to the holding company at par. It might at first appear that the portion of the surplus which immediately attached to the new stock should be eliminated. However, since the objective is to show the surplus earned by the consolidated group and since the subsidiary company was a part of the consolidated group when the $25,000.00 was earned, only the purchased surplus, that is, the $50,000.00 surplus at date of acquisition from outside interests should be eliminated.

ARTICLE No. 3

By M. M. Stone, New York Thirty-ninth Street Office

The ever increasing trend of industry today toward the formation and operation (usually for purposes of management and financial control and also to limit the liability of each corporate entity) of holding or parent, and subsidiary, affiliated, and/or related companies, has made it necessary for accountants, particularly those serving the general public, to familiarize themselves with the principles of law and accounting involved in the presentation of a complete picture of the financial position and results of operations of the group from the viewpoint of a single organization or business unit.

Whether we are concerned with balance sheets exhibiting financial condition or with income statements, the presentation may be in the form of individual statements for each of the companies, properly combined, or by one consolidated statement after inter-company items have been eliminated. It is elementary that the investment by the parent company in capital stocks of its subsidiary or affiliated companies must be eliminated in the preparation of a consolidated balance sheet.

In a consolidation, however, it is the valuation of the underlying net assets supporting the parent's investment in which we are interested rather than the capital stock investment itself.

We may also find it necessary, in some manner, to dispose of the surplus or deficit of a subsidiary company or a part thereof in completing and presenting a true picture of the "business unit."

Many parent companies are constantly increasing their holdings by acquiring other companies and the surplus or deficit at the date of such acquisition must be given consideration not only for the purpose of exhibiting the situation properly in the balance sheet, but to measure and present the results of operations for the period during which the enterprise has operated as a single organization.

There are many phases of the subject "Surplus at Date of Acquisition," and the surrounding conditions found to exist in respect of each case met with in actual professional practice must be carefully considered in reaching a conclusion as to the proper treatment of such a surplus in the accounts and on financial statements.

The particular phase of the subject which will be discussed in this article, is the manner of treating in a consolidated statement the capital stock and surplus accounts when the entire capital stock of a company has been purchased by another company at less than the book value of such stock.

Assuming the subsidiary company to have capital stock outstanding of a par value of $100,000 and a surplus at the date of acquisition of $50,000, the net worth of $150,000 being represented by tangible assets carried at a fair valuation; and assuming further that as a result of shrewd trading, the entire capital stock was purchased at a total cost of $130,000:

By the purchase of the entire outstanding capital stock of the subsidiary, the parent company, in effect, acquired all of the net assets of the subsidiary company and it follows that any dividend paid out of the surplus at the date of acquisition would represent a recovery of capital, and not income, to the parent company. In other words, the result to the parent company of receiving such a dividend would be merely the conversion into cash of a value previously carried as an investment item. Looked at from another angle, because of the reduction in the net assets of the subsidiary company by the payment of a cash dividend, the net worth of the subsidiary company would be reduced and correspondingly the valuation of the investment by the parent company should be reduced.

It is clear then that as a first consideration, the surplus of the subsidiary company at the date of acquisition should be regarded as surplus not available upon transfer for the payment of dividends upon its outstanding stock.

It is apparent also that irrespective of whether or not dividends were declared and paid by the subsidiary company out of surplus at the date of acquisition, and unless or until the books of one or both of the companies were adjusted, there would always exist a difference of $20,000 between the value of the stock of the subsidiary as shown by its books and as represented by the investment account balance on the books of the parent company. In the absence of entries on the books to adjust this difference, it would be developed in the preparation of consolidated statements by the application of elimination items and the question would then arise as to how the excess of the capital stock and surplus credit balances over the investment account debit balance should be described.

To give proper consideration to this question, it would be necessary to ascertain, in so far as might be possible, the facts as to values acquired through the acquisition of the capital stock of the subsidiary company. In other words, was the surplus at the date of acquisition a legitimate surplus based upon proper valuations of assets or did there exist some overvaluation of plant, inventory, accounts receivable, or other asset, the recoupment of which overvaluation was, or would be, subsequently effected through operating or profit and loss accounts of the subsidiary company? If it could be determined that the latter is the case, it is obvious that in the preparation of consolidated statements the excess credit balance should be regarded as representing an overvaluation of assets and therefore should be applied in reduction of the assets involved (or carried as a reserve against the valuation of such assets) unless or until such assets have been charged off through cost of sales, depreciation, or otherwise. To the extent that there has been such a charge-off, the credit balance should be treated as profit and loss surplus.

On the other hand, and as stated in the assumed case cited in this article, if stock represented by tangible assets carried at a fair valuation was acquired as a result of shrewd trading at less than its book (and actual) value, there would be no question that a potential profit had been made by the parent company; and although such profit does not appear until a consolidation is made of the accounts of the two companies (or until the investment account on the books of the parent company is written up to agree with the true net worth of the subsidiary company) it is in the nature of a real profit and should be so regarded by inclusion in the consolidation as "excess of capital stock and surplus at date of acquisition of .... company over cost thereof to .... company," or some other appropriate caption.

Altering the assumed case to one in which good-will is carried on the books of the subsidiary company, and removing the assumption that the stock had been acquired at less than book value merely as a result of shrewd trading, it would be proper to consider that the good-will valuation was fictitious and in that case the excess credit balance should be applied in reduction of good-will in the preparation of the consolidated balance sheet.

To summarize, then, in the case assumed in this article:

1. In consolidation, surplus at date of acquisition of a subsidiary company should be regarded as surplus not available for distribution by the parent company, as dividends paid out of this surplus reduce the net worth as of the date of acquisition and when received by the parent company should be applied in reduction of its investment.

2. Provided the accounts under consideration have not been adjusted in the books of either company, the excess of the subsidiary company's net worth at date of acquisition over the cost of the investment by the parent company will exist until the investment is disposed of by sale, until dissolution of one or both companies, or until some change takes place in the corporate structure.

3. The excess of the subsidiary company's net worth at date of acquisition (supported by net assets properly valued) over the cost thereof to the parent company should be considered in the consolidation as surplus and appropriately described in the statements prepared and submitted.

In conclusion, it should also be borne in mind that if the assets (including both tangible and intangible) supporting the subsidiary's net worth have been overvalued, the excess of capital stock and surplus at date of acquisition over the cost thereof to the parent company is not surplus and should be applied in reduction of those assets in the consolidation; and, to the extent that the overvaluation of the assets has been realized through charges to operations, the excess would be profit and loss surplus, representing merely an offset to such charges.

News Items

WE have pleasure in announcing the appointment of Mr. C. R. Olin, Jr., as assistant manager of our Cincinnati office, effective July 1.

Mr. Rossetter presented a paper on "The Natural Business Year" before a joint meeting of the Illinois Society of Certified