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Some Shortcomings in Consolidated Statements*

By Percival F. Brundage

The subject "consolidated statements" is not a new one, but it has become increasingly important in the last few years, during which many of our industrial and public-utility companies have been expanding and acquiring control of other companies. This development is reminiscent of the first few years of this century but has given rise to new problems. I, therefore, feel justified in introducing the subject again.

I am not going to discuss the mechanics of consolidated accounts or their advantages, which, I believe are well-known and generally accepted. 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 can not be obtained by analyzing and comparing a number of individual statements. But there are occasions when I do not think it is desirable to submit consolidated statements alone, when it seems to me that they may lead to an incomplete and inaccurate picture of the financial position and operations of a parent company and its subsidiaries. I am, therefore, going to raise a few questions concerning the shortcomings of consolidated statements, which I hope will provoke discussion.

(1) In the first place, there are many reasons why a stockholder is interested, or should be interested, in receiving a balance-sheet of the parent or subsidiary company whose stock he owns. Take a simple case of two manufacturing companies. One owns 100% of the other's common stock, but both companies have preferred stock and mortgage bonds outstanding. The parent company publishes in its annual report a consolidated balance-sheet and income account. The combined current assets amount to $1,000,000 and the current ratio is 2 to 1. From the combined statement alone, however, a common or preferred stockholder can not tell what the quick position of his own company is, how much cash it has, or what is the surplus available for dividends. A common stockholder of the parent company may assume that the cash and earned surplus of the subsidiary can be transferred at any time by the mere declaration of a dividend, but, as we all

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know, this is not so simple. The subsidiary company's bond or preferred stock indentures may require that a certain ratio of current assets to current liabilities be maintained or that the current assets must exceed the current liabilities plus the total par value of bonds or preferred stock outstanding before dividends can be paid on the common stock. There may also be sinking-fund requirements to be met during the next few months, or there may be local considerations making it inadvisable to transfer the surplus by the declaration of a cash dividend or even by a credit to the parent company's account. These questions are also very important if the subsidiary is operating currently at a loss. To consider that a stockholder can obtain all of the important information in which he is interested from a consolidated balance-sheet is a fallacy. This, one may think, is obvious, but the preparation of consolidated accounts has become so general that it is sometimes overlooked.

(2) The creditors of a parent company or its subsidiaries are particularly handicapped in any reliance that they may place on consolidated statements. The principal assets shown may not be those of the company whose creditors they are, and even if the total assets are more than sufficient to meet the claims of the creditors of the respective underlying companies, the excess in liquidation might be distributed to outside preferred stockholders of a subsidiary and not become available for the creditors of the parent company through liquidating dividends on the subsidiary's common stock.

It is difficult satisfactorily to explain the liens in a consolidated statement. The parent company may have pledged the stock of a wholly owned subsidiary, which is consolidated, under its own collateral notes or bonds. In addition, there may be pledged the securities of certain companies, not consolidated, and various other assets. To mention the pledge of the miscellaneous investments without referring to the fact that a portion of the consolidated current assets are those of a subsidiary whose capital stock is pledged is not altogether satisfactory. On the other hand it is often impossible, in a large consolidation, to give an adequate explanation of the different liens and assets pledged without destroying the clarity of the statement and making it unintelligible to the average reader.

The federal reserve board will not accept for rediscount the notes of one of a group of companies without the submission of an individual balance-sheet as well as the consolidated accounts. It may be that creditors generally are entitled to more information than they have been receiving. Too often in preparing the annual accounts or statements for the banks the only alternative considered has been whether to submit consolidated figures or those of the parent company alone. In many cases it may be wise to submit both consolidated statements and separate balance-sheets of the parent company and important subsidiaries or separate exhibits containing the details regarding the various assets and liabilities of the different companies consolidated.

(3) The question as to what companies to consolidate is frequently an important one. A great deal has been written about the theory of economic unity, to the effect that the operations of those companies, whether included in a vertical or horizontal combination, that produce or supply an economic need of the community should be consolidated. This, however, is not always easy to apply. The accounts of a chain of drug stores may be consolidated with the accounts of a subsidiary company manufacturing shoe polish. Let us assume that the subsidiary then develops the manufacture of stove polish, which is sold in large volume to an entirely different class of trade. 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. It is only after weighing such questions as these that we can decide whether a consolidated statement or individual statements will more clearly reflect the facts.

During the last few years numbers of finance companies have been organized and it has generally been found advisable to separate the operations of such companies from the consolidated group and to publish separate statements with the annual reports. This may apply also to any operation distinctly apart from the sphere of activity of a consolidated group.

The percentage of ownership necessary to make consolidation desirable also varies in different circumstances. I, personally, am inclined to think that with even a small minority interest outstanding, a consolidation is sometimes misleading. 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. The New York Central Railroad has not prepared consolidated statements to include the Michigan Central Railroad, although over 99% of the stock has been owned for several years. In the case of any company considering the purchase of an interest in a consolidated group, it is particularly important that the situation with respect to the minority interest outstanding be clearly stated and understood.

The amount of the deficit of subsidiary companies to be charged against the holdings of the minority interests may also be considered. It has been advocated that a proportion of the deficit should be applied to the minority stockholders and deducted from the value of the capital stock shown as outstanding in the hands of the public. This, it seems to me, is not always sound. The parent company frequently finds it necessary for financial or operating reasons to acquire the holdings of the minority interest and it is difficult to obtain them at the actual book value. My own preference has been to consider that all of the operating losses of partly owned subsidiaries should be absorbed by the parent company so long as there is no earned surplus on the books of those companies to which they can be charged.

(4) The adequate description and classification of the assets in a consolidated balance-sheet is sometimes difficult. The inventories of the various subsidiaries may not be taken on exactly the same basis and there may also be considerable variety in the basis of valuation of other assets. In one case that has come to my attention, three subsidiaries were acquired at about the same time. The fixed assets of two were appraised and taken on the books of new companies formed for the purpose at the appraised value in exchange for shares of capital stock which were acquired by the parent company. The assets of another and larger company were taken over at the old book values, representing pre-war cost less ample depreciation charges. The combined figures for fixed assets were almost meaningless. Subsequently the fixed assets of

the third company were appraised and the excess over book values was credited to "capital surplus resulting from appraisal" although just as truly a portion of the original capital of the consolidated group as the stock given for the excess of appraisal value over cost of the other subsidiaries.

In the case of a parent company with a number of foreign subsidiaries the consolidated figures may be quite misleading. Cash in foreign currencies may not be readily transferable, with unstable exchanges and export restrictions in certain countries. Inventories in a foreign country may almost become fixed assets if the business conditions in that particular country are bad. The cost of re-shipping stock may be considerable and the possibility of damage in re-shipment important. The merchandise may have been made to meet the requirements of the particular market, language or currency. 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 net quick assets of the foreign subsidiaries as one figure, without consolidating them in detail.

(5) In the case of certain consolidations it sometimes happens that the accountant certifying the accounts of the parent company and consolidated group has not audited the accounts of all of the subsidiaries. It is usually the custom to mention the fact that the statements of certain subsidiaries have been accepted as certified by other accountants, sometimes naming the companies and sometimes naming the other accountants, but it is seldom that the amounts of the respective assets or earnings concerning which the qualification is made are indicated in the consolidated statements. If the auditor certifying the combined accounts has any real doubt as to the accuracy of the figures of the subsidiaries, it would seem that some reference should be made to the amount of the assets or earnings to which the qualification applies.

(6) The preparation of statistics is difficult and frequently misleading if consolidated figures alone are available. The computation of the percentages of gross profit to sales, expenses to sales, turn-over of accounts receivable and inventories, etc., should be based on the figures of the individual companies, and not on con-

solidated figures, to be most significant. A 2% net profit on sales may represent the combination of a 15% profit for one company and a loss for several others.

From consolidated statements alone it is not possible to tell which companies are making money, and that is sometimes quite significant. It may be that the greater part of the consolidated earnings are contributed by the company with the smallest capital while the company with the largest inventories and plant investment is operating in red figures.

In good times a consolidated group of companies may be operating successfully but after a few years of losses, a break-up may find the most profitable unit under the control of the bondholders or preferred stockholders on account of a temporary default in interest payments or dividends. This may destroy the unity of the consolidation, the dangers of which would have been more apparent before if separate statements of the individual companies had been published.

A stockholder is sometimes in the position of not receiving adequate information until a receiver is appointed. He is then like the farmer whose boy was found by a motorist looking disconsolately at a load of hay upset in the road. "Why don't you run and tell your father," asked the motorist. "He knows," replied the boy. "Knows? How does he know?" said the motorist. "He's under the hay" was the reply.

(7) A consolidated profit and loss account may be quite misleading. The figure for consolidated profit before bond interest, in the case of a group of public-utility companies, may require analysis if there are large preferred stock issues of subsidiaries outstanding in the hands of the public. Dividends on such preferred stocks may be deducted below in the consolidated statements, although a prior charge on the earnings of the subsidiaries. This is a very important consideration in computing the number of times interest charges are earned. This same question also arises in the case of federal taxes on earnings of subsidiary companies where consolidated returns are not prepared. In such cases the federal taxes must be paid or provided for before the earnings can reach the parent company and become available for interest charges, which may be deducted above in the consolidated profit-and-loss account. In consolidated statements where the depreciation is deducted separately and earnings are shown as "available for depreciation and interest," it may be difficult to

determine the amount of the actual earnings available for interest on the obligations of the parent company.

Conclusion

The English answer to certain of the above questions has been to submit the balance-sheet of the parent company and to separate the investments in the balance-sheet of that company as between those of wholly owned and controlled companies and those in which the parent company has a minority interest. More recently, it has also become the custom to indicate the equity in the net earnings of subsidiary companies as compared with the dividends received, but so far as I know, consolidated statements have been submitted only in rare cases as supplementary to the "legal balance-sheet" of the parent company and little attempt has been made to set forth the underlying assets of the subsidiaries.

In our efforts to obtain a full disclosure of all important facts in the published accounts which we certify, we are frequently met by the objection that competitors will profit by the information given out. The danger of attracting competition in the more profitable branches of the business is, of course, an important point to be considered. There is also the bugbear of the Sherman act and governmental regulation.

On the other hand, more and more information is being supplied to stockholders and creditors in the annual reports of our larger companies. The American Telephone & Telegraph Company is one of the leading companies which submits a parent company balance-sheet as well as a consolidated balance-sheet in its annual accounts. The United States Steel Corporation obtains similar results by publishing in its annual reports complete details regarding all important items in the consolidated balance-sheet. This is quite in line with the modern principle of more publicity and complete information to the stockholders and general public. In many cases it has been found that the disclosure of more detailed information has not been harmful but rather helpful, and that competitors have ways and means of ascertaining important information in which they are interested other than from the published accounts. Investors, generally, during the last few months are showing more and more appreciation of the necessity for analysis and study of the financial statements of the companies in which they are interested. The New York stock exchange has been constructive in requiring more complete and detailed statements. Investment counsel, investment trusts, and the various statistical services are continually making detailed studies of the various companies in each industry, and the securities of that company which is most open and above-board in furnishing complete information frequently have a better investment rating and marketability and the prices are subject to less violent fluctuation than are those of the companies concerning whose operations only rumors are current on the "street."

In our audit reports it is possible to submit individual balance-sheets of all of the companies, possibly in the form of columnar consolidating statements accompanied by adequate comments and supporting details which, however, usually fail to reach the stockholders. For the purpose of discussion, therefore, the following suggestion is offered for the published accounts; i.e., condensed columnar balance-sheets and profit-and-loss accounts, showing in the first column the parent company's figures alone; in the second column the combined figures resulting from a consolidation of the wholly owned domestic subsidiaries; in a third column the combined figures resulting from a consolidation of any wholly owned foreign subsidiaries; fourth a column for eliminations; and, fifth, the consolidated totals. This, it seems to me, may meet our clients' objection to giving out detailed figures concerning the financial position and operations of each of the companies but will also give some valuable information including that most essential, from a legal standpoint, to the security holders and creditors of the parent company. This should also be supplemented by separate balance-sheets and operating statements for each company having outside preferred stockholders and bondholders to whom these statements should be sent. A further amplification is also suggested in cases where the controlled but non-consolidated companies are important, namely, to add an additional column containing the combined figures for the controlled companies in total, giving in the report or as a footnote the names of the companies with the proportionate interest of the parent company in each and in the total net worth and earnings but without attempting to allocate or indicate the proportion of the respective assets applicable to the parent company.