1-1932

Some Difficulties Arising in Consolidated Financial Statements

Walter A. Staub

Some Difficulties Arising in Consolidated Financial Statements*

By Walter A. Staub

The difficulties which arise in the preparation of consolidated financial statements, whether balance-sheet or income account, may be broadly grouped in two classes. One class consists of those difficulties which arise in the application to concrete cases of principles or concepts which have become recognized as fundamental to the preparation of financial statements for two or more corporate entities which constitute an economic or financial unit.

The second class of difficulties includes those which do not involve the application of a principle peculiar to consolidated statements. In such instances it is purely fortuitous that the difficulty has arisen in the course of preparing consolidated statements, and the same principles as apply in the case of single unaffiliated companies are to be followed.

It is the primary purpose of this paper to deal with some of the difficulties and problems falling in the first of the two classes mentioned.

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. Or again, if the dividends received from the subsidiaries during a fiscal year materially exceed the actual earnings of the subsidiaries during such period a disclosure should be made. Of course, if the dividends are out of profits accumulated by the subsidiaries prior to the acquisition of their stocks by the parent company, such dividends should not be included in the income account of the parent company at all;

*Address delivered at the annual meeting of the American Institute of Accountants, September 16, 1931, at Philadelphia, Pennsylvania.

they are merely a return of capital invested in the stocks of the subsidiaries.

It is surprising how the fact of a business enterprise embracing several separate corporate entities seems for some people to obscure fundamental principles. Let us assume a business carried on by a single corporation, which has a number of branches and that the branch managers participate in the profits and losses of their respective branches. No business man would for a moment question that before the balance-sheet and income account of this business can be considered complete—or correctly stated—the results of the operations of all the branches must be brought into the picture and that effect must be given to each branch manager's interest, first by setting aside from the profits the portion accruing to him, and secondly by charging against the combined profits that portion of the branch loss to be borne by any manager which it appears will not probably be collected from him.

Now, if in the situation above outlined various branches or departments of the enterprise happen to be separately incorporated and the interest of the managers is represented by the interest of minority stockholders in the subsidiaries, the principles underlying the preparation of complete and correct financial statements are absolutely the same. The results of each subsidiary's operations and its financial position, including especially its liabilities, must be included, and the effect of the minority interests must be considered, either in crediting them with that portion of the profits to which they are entitled or by charging into the consolidated income account those losses which the minority interests in theory should bear but in fact are likely to fall on the affiliated group.

This is all so elementary in principle that I almost feel that I should apologize for referring to it. Nevertheless, officers and directors of corporations have on more than one occasion set up statements which have been just as defective as though the operations and financial position of one or more branches had been omitted from the statements of a single corporation, or the effect of the branch managers' interests not recognized, and have endeavored to persuade the accountant that, because of the separate corporate entities involved, their procedure was justified. It cannot be emphasized too strongly, even at the risk of repeating the trite and obvious, that especially in this day of huge and complex business enterprises financial statements must disclose fact and substance and that subdivision of an enterprise into a number of separate corporate entities must not serve nor be availed of to conceal the true situation with respect to either financial position or operating results. Difficulties will frequently arise in the practical application to complex situations of principles which may be relatively simple in themselves. Here the accountant can make a vital contribution to the protection of the interests of creditors and shareholders of business enterprises by insisting on the application of sound principles, while aiding in the solution of the difficulties arising in the course of their practical application.

BASIS FOR CONSOLIDATING ACCOUNTS

One of the most difficult questions which constantly arises in practice is the determination of when companies not wholly owned should be included in a consolidated balance-sheet, or when they should be excluded. Almost every shade of opinion has been expressed on this point, varying from the suggestion that companies in which there is a bare voting control should be consolidated, up to the requirement of a large percentage of both voting control and financial interest. Apart from the question of what percentage of stock ownership would justify consolidation, the question has sometimes been raised as to the propriety of including in the consolidation a company in which a large stock ownership is held by the parent company but the stock is deposited under a voting trust running for a period of years. In theory, at least, this may prevent the parent company from exercising management control if the voting trustees do not choose to consider its wishes respecting the directorate of the subsidiary.

It seems clear that no arithmetical rule can be laid down requiring, for example, that all companies over a certain percentage of stock ownership shall be consolidated, and all others below the named percentage not consolidated. The circumstances of each case must be considered, and there are too many factors involved to permit a simple rule of this kind.

Among the factors which naturally call for consideration are percentage of stock ownership, class or classes of stock owned, voting control or absence thereof, management control, and economic or other relations to parent or other companies in the affiliated group. For example, the Western Union Telegraph Company includes in its consolidated balance-sheet properties held under perpetual leases and merged in the Western Union system, even though there is no stock ownership. The properties of companies held under term leases are not, however, included in the consolidated balance-sheet.

In speaking of percentage of ownership, one naturally thinks first of common stock ownership, but this question is not always as simple as it might at first seem. There may be another class of stock which, while not termed "common," is in much the same class, except that it may not have voting rights, or its voting rights may be much smaller proportionately than those of the common stock. There may be participating preferred stock which shares in the earnings of the subsidiary after such participating preferred and the common have each received a stipulated rate or amount per share.

The voting control of Company A may be lodged in a small percentage of its total outstanding capital stock. For example, assume that the voting control rests in stock representing, say, 25 per cent. of the total capital stock, and the other 75 per cent. is in shares having the same rights as to distribution of profits, distributions in voluntary or involuntary liquidation, etc. Company B, which owns the majority of the voting stock, may have only, say, 13 per cent. of the total capital stock of the company. It might lead to distortion of the financial picture to prepare a consolidated balance-sheet and consolidated income account for the two companies.

The factors of management control and intercompany economic relations, where there is less than 50 per cent. stock ownership, might not ordinarily be thought of as sufficient to warrant consolidation. Yet, they should receive consideration because the intercompany relations may be such that the company owning a minority of the stock and having the management control may, for the sake of its own business, have to finance operating losses of such an affiliated company.

Because the circumstances of each case may have so large a part in determining whether or not a given company should be included in a consolidated balance-sheet, there has been little effort made to state an arithmetical rule. It is of interest to note, however, that there are at least two large companies, whose stock is listed on the New York stock exchange, which have given expression to an arithmetical measure for their own use, and it is further of interest to note that both of them have set the figure at

75 per cent. The Anaconda Copper Mining Company and the North American Company have both indicated in their annual reports that companies in which they have a stock ownership of 75 per cent. or more will be consolidated, but not companies in which the ownership is less than that percentage.

The North American Company in its report to stockholders states its policy as follows:

". . . your company . . . classes as subsidiaries only companies in which it or its subsidiaries own voting control and at least 75 per cent. of the common stock and does not include in its consolidated income statements undistributed earnings applicable to substantial investments in other large public utility companies."

It is interesting to note the following definition of the term "subsidiary company," which appears in the English companies act (1929):

(1) Where the assets of a company consist in whole or in part of shares in another company, whether held directly or through a nominee and whether that other company is a company within the meaning of this act or not, and

(a) the amount of the shares so held is at the time when the accounts of the holding company are made up more than 50 per cent. of the issued share capital of that other company or such as to entitle the company to more than 50 per cent. of the voting power in that company; or

(b) the company has power (not being power vested in it by virtue only of the provisions of a debenture trust deed or by virtue of shares issued to it for the purpose in pursuance of those provisions) directly or indirectly to appoint the majority of the directors of that other company,

that other company shall be deemed to be a subsidiary company within the meaning of this act, and the expression "subsidiary company" in this act means a company in the case of which the conditions of this section are satisfied.

It is to be noted, however, that this definition was not formulated for the purpose of setting a standard for the preparation of consolidated balance-sheets, but for the application of those provisions of the act which call for the segregation of investments in and acounts receivable from and payable to subsidiary companies in balance-sheets of the parent company and for an explanation of the manner in which the earnings of subsidiaries have been treated in stating the income of the parent company.

The foregoing definition of a subsidiary is also of interest in considering the suggestion contained in the helpful address at last year's meeting of the Institute by J. M. B. Hoxsey, executive assistant to the stock-list committee of the New York stock exchange, that consolidated accounts might "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." In an address which Mr. Hoxsey delivered before the New York State Society of Certified Public Accountants in April of this year, he referred to the above suggestion and elaborated it as follows:

"Among other things which I touched on in Colorado Springs was the subject of consolidated accounts. I voiced there the thought that there should enter into the consolidation all subsidiary companies, more than fifty per cent. of whose equity * stock was held by the holding company. As a result of that meeting there was appointed a committee of the American Institute of Accountants on coöperation with stock exchanges.

"Generally speaking, I believe that committee is in agreement with most of the things advanced in the paper but upon that particular matter they were adamant in refusing to agree. Personally of course I know that they are all wrong, but however that may be, what the stock exchange is trying to do is to get a consensus of opinion as to what are proper accounting methods and practices, and if we can not convince a committee of the most eminent accountants in the country that our position has been right on that then there is nothing to do but to cease butting our heads against a stone wall and change our requirements, and therefore since we have learned the views of these accountants on that we have changed the requirements of the listing committee and no longer require the same degree of consolidation as we have done heretofore, but are satisfied if the effect of the undistributed earnings of unconsolidated subsidiaries is shown upon the report submitted, either as an element in the consolidated income account as a separate item, with of course appropriate valuation of the assets thereby affected in the consolidated balance-sheet, or if not there, at least in a footnote.

"We do still insist however that the net result at least of operation of the system as a whole should be made fully known to the stockholders and we found no accountant who disagreed with that view."

The June 2, 1930, edition of the New York stock exchange requirements for listing applications called for an agreement on the part of the applicant corporation to furnish its stockholders annually with its own balance-sheet and income and surplus

* In Mr. Hoxsey's Colorado Springs paper he referred to voting stock.

statements for the last fiscal year, and similar statements for each corporation in which it held directly or indirectly a majority of the *voting* stock. The applicant company would be permitted, in lieu thereof, to furnish either (a) a similar set of statements fully consolidated for the group of affiliated companies: or (b) a similar set of statements consolidated as to the applicant company and specifically named or described subsidiaries, with separate statements for each unconsolidated corporation in which a majority of the voting stock was directly or indirectly held.

In a recent revision of the listing requirements, the above basis was changed from the holding of a majority of *voting* stock to a majority of *equity* stock, and it is further provided that if the consolidated statements exclude any company, the majority of whose equity stock is owned, the following requirements must be met:

(a) the caption of the statements must indicate the degree of consolidation;
(b) the income account must reflect, either in a footnote or otherwise, the parent company's proportion of the sum of or difference between current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of report; and
(c) the balance-sheet must reflect, in a footnote or otherwise, the extent to which the equity of the parent company in such subsidiaries has been increased or diminished since the date of acquisition, as a result of profits, losses and distributions.

The applicant company must also agree that "appropriate reserves, in accordance with good accounting practice, will be made against profits arising out of all transactions with unconsolidated subsidiaries, in either parent company statements or consolidated statements."

The change from the use of voting stock to equity stock, as the basis for the definition of subsidiaries, is important. Equity stock, as I understand the exchange's definition of it, would include not merely common stock having voting power, but would also include any other class of stock which is on substantially the same basis as common stock, even though it does not have voting power or has it only in certain circumstances, such as the passing of dividends. In such cases the exchange would consider both classes of stock as equity stock and, it would seem to me, properly so. There is an interesting question as to whether or not participating preferred stock should be considered as equity stock. The provisions of participating preferred stock vary so much that it is quite possible that some issues could properly be classed as equity stock, while other issues would be excluded from that class. It would appear that the purpose of this change is to require not merely voting control but also a majority of the investment which is entitled to the earnings after all prior charges, including preferred dividends, are met.

The following is suggested as a general rule, so far as one can be stated, for the inclusion of subsidiaries in consolidated statements:

Companies in which 75 per cent. or more of the equity stock is owned by the parent company should ordinarily be consolidated;

Companies in which between 50 per cent. and 75 per cent. of the equity stock is owned, may be consolidated, depending on the circumstances of the particular case;

Companies in which 50 per cent. or less of the equity stock is owned should be consolidated only in unusual cases. Consolidation of companies in the last mentioned class must rest on the peculiar circumstances of each case and should be resorted to only for obviously strong reasons.

EXCLUSION OF A WHOLLY-OWNED SUBSIDIARY

The question has been raised whether there are any circumstances in which it is proper to exclude one or more of the wholly-owned subsidiaries from consolidated statements. As a general rule, if a consolidated balance-sheet is prepared at all, every wholly-owned company should be included. The United States treasury has consistently held to this principle with respect to consolidated income-tax returns and has insisted ever since 1922 (when the option given affiliated companies of filing either consolidated or separate returns was first incorporated in the revenue acts) that the option must be exercised "all or none" (excepting as to foreign subsidiaries and certain other exceptions named in the law). In other words, partial consolidation is not permitted. This seems reasonable with respect to tax returns.

In the case of financial statements submitted to stockholders or used for credit purposes, an argument is sometimes made for excluding a wholly-owned subsidiary from the consolidated statement, where the nature of its business is such that it is informing to show it separately. For example, General Motors Corporation excludes from its published consolidated balance-sheet the General Motors Acceptance Corporation, its wholly owned finance subsidiary. Since the beginning of 1929 the earnings of that subsidiary are included in the consolidated income account. The business of the General Motors Acceptance Corporation is of a financing or banking nature, while that of the General Motors Corporation and its subsidiaries generally is of an industrial character. It is to be noted that the General Motors Corporation includes in its annual report a separate balance-sheet of its Acceptance Corporation.

In the case of another company of substantial size, whose stock is listed on the New York stock exchange, which publishes a consolidated balance-sheet, a wholly-owned company in an apparently related business is not consolidated and in the text of the company's annual report the statement is made that the investment in the unconsolidated subsidiary has a value double that at which it is carried in the balance-sheet. No reason is given for not consolidating this wholly-owned subsidiary, nor is any indication given of what the earnings of this unconsolidated subsidiary have been.

Some corporations, as a matter of regular practice, do not combine the accounts of their foreign subsidiaries in consolidated statements. There would seem to be no particular objection to this practice if (1) due notice thereof is given in the statement, (2) if the foreign subsidiaries have not sustained losses, and (3) if no unrealized intercompany profit is included in the otherwise consolidated statements.

The danger of excluding any subsidiaries from the consolidated statements is well brought out by a recent occurrence which attracted much attention in the financial world. The stock of a company doing a world-wide business was actively traded in on the New York stock exchange and the annual report to the stockholders included a consolidated balance-sheet and consolidated income account. No accountant's certificate appeared on the financial statements. In the bankers' prospectus offering a large issue of the company's debentures to the public appeared a statement by the chairman of the company's board of directors that the earnings of the company for recent years as stated in the prospectus were substantially less than those previously published in the company's reports to its stockholders, and that the differences arose chiefly from the fact that the earnings previously reported were not fully consolidated and included profits on goods billed to certain subsidiaries before such goods had been sold by the subsidiaries.

Whenever special circumstances appear to justify the exclusion of a wholly or largely owned subsidiary from the consolidated statements of an affiliated group, a vital requirement is "disclosure," and a separate balance-sheet for the unconsolidated subsidiary or subsidiaries (and income account, if their income is not included in the consolidated income account) would usually meet this requirement.

It is of especial importance that no unprofitable subsidiaries (whether wholly or partly owned) be excluded from the consolidated statements without provision for their losses or adequate disclosure of the facts.

RESTRICTION ON DISTRIBUTION OF SUBSIDIARY EARNINGS

A matter which has had some discussion, particularly in relation to the consolidated income account, and also the consolidated surplus on the balance-sheet, has been whether or not any restriction which might interfere with the paying over of subsidiary earnings to the parent company must be considered in stating the consolidated income. Earnings of the subsidiaries must find their way, through the road of dividends or interest, into the treasury of the parent company in order to be available for meeting the dividends or interest on the latter's securities. Among the restrictions which may retard or limit the flow of income from the subsidiaries to the parent company are:

(a) Deficit on the books of a subsidiary at the date of its acquisition; the laws of most states would require that income subsequently earned by that subsidiary be retained to wipe out its deficit and only after that had been accomplished would its earnings be available for dividends to the parent company;

(b) Requirements for the subsidiary to retire bonds or preferred stock through a sinking fund appropriated from income, where by the terms of the legal instrument no part of the sinking fund appropriation shall be available for dividends on the common stock so long as any of the securities subject to redemption through the sinking fund shall be outstanding;

(c) The declaration of stock dividends by the subsidiary, thus making the earnings of the subsidiary, to the extent that they are transferred to its capital-stock account by reason of the stock dividend, unavailable for cash dividends;

(d) The financing of plant extensions by a subsidiary through application thereto of its profits, thus leaving it without the cash required to pay over its earnings to the parent company.

In general it may be pointed out that these restrictions would apply just as effectively in the case of a single company as in an affiliated group and still would not be deemed to prevent the inclusion of the company's full earnings in its stated income account. From a practical standpoint, restriction (a) could be readily disposed of through a reduction of the par or stated value of the stock of the subsidiary or through other form of reorganization. This would be an intercompany transaction which would have no effect on the consolidated balance-sheet and at the same time would meet the legal point with respect to the inability to pay dividends during the existence of a deficit.

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 of the surplus, would be made after showing the consolidated income for the year and would be merely an appropriation thereof to a special surplus account instead of transferring the entire amount of the year's net income to the general or unrestricted surplus.

An intercompany stock dividend, item (c), effects no real change in the consolidated surplus. In dealing with the accounts of the several companies separately, the parent company would be warranted in crediting its income account with the same amount for the stock dividend received as the subsidiary company charges to its surplus account for the payment thereof. In consolidated statements such transactions are eliminated and produce no effect on the consolidated net income. The payment of a stock dividend by the subsidiary is not different in principle from utilizing cash realized from consolidated earnings to purchase stock of a new subsidiary or additional stock of an existing subsidiary.

With respect to item (d) the same observation may be made in the case of an affiliated group as in the case of a single company. Even though a considerable portion of the year's earnings may be reinvested in plant additions, the income is nevertheless stated at the full amount of the earnings, even though such investment in plant makes a portion of the income unavailable for cash dividends.

SURPLUS OF SUBSIDIARIES AT DATE OF ACQUISITION

While the principle of eliminating the surplus of subsidiaries at dates of acquisition is clearly recognized by the accountant, it is apparently not always readily recognized by business and financial interests. Where the parent company issues its own stock to acquire the stock of a subsidiary and the stated or par value of the parent company's stock is less than its fair market value, there may be a proper credit to capital surplus in the consolidated balance-sheet, representing the difference between the par or stated value of the parent company's stock and the value of the subsidiary's assets. Part of this difference may be represented by the surplus of the subsidiary at acquisition, as in cases where stock is exchanged par for par. However, the surplus so resulting is in fact capital surplus and must be shown separately and not merged with the consolidated earned surplus.

There have been cases where the pre-acquisition surpluses of subsidiaries have been carried forward into the consolidated balance-sheet and, in order to effect a balance, the assets of the subsidiaries have been written up above their cost to the subsidiary and likewise above the cost of the subsidiary's stock to the parent company. This is tantamount to a company writing up its own assets on an entirely arbitrary basis and without disclosure.

CONSOLIDATING ACCOUNTS OF DIFFERENT FISCAL PERIODS

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.

As a matter of fact, prospective investors would get a more informing presentation of the situation after the consolidation is effected than they would if merely separate balance-sheets were shown. This seems to be a case where pure technique yields to practical considerations.

If the balance-sheet dates are separated by a considerable period, if differences in seasonal conditions at the respective dates cause the balance-sheets to be on dissimilar bases, or if there are other causes which tend to create a divergence of basis because the balance-sheets are not as at precisely the same date, a consolidated balance-sheet would not be justified.

The test would be what has been indicated above, viz.: (1) Are the balance-sheets in such relation to each other that a distorted picture would not result from consolidating them; and (2)

Does the consolidated balance-sheet tend to result in a more informing picture than the separate balance-sheets?

A firm or exclusive rule can not be laid down for this class of cases. The special circumstances of each case must determine the course to be followed. Strict adherence to technique should not, however, be at the expense of practical benefits that may follow from a relatively immaterial departure from technicality.

ACQUISITION OF SUBSIDIARY "AS AT" AN EARLIER DATE

The stock of a subsidiary is often acquired as at an earlier date, and a question arises as to the date to be used in determining surplus at acquisition and the earnings of the subsidiary to be included in consolidated income. The guiding principle here is whether or not the circumstances indicate that the earnings subsequent to the "as at" date were considered in determining the purchase price, since if the subsidiary's earnings have been paid for they clearly can not constitute part of the consolidated earned surplus.

Where, for example, an agreement to purchase the stock at a stipulated price is signed on June 30th, contingent upon an audit supporting the accuracy of the accounts and, because of the time required for the audit and legal details, title to the stock does not pass until August 31st, it is entirely proper to treat the acquisition as of June 30th. On the other hand, if negotiations for the purchase of stock begin on March 31st based on a previous December 31st balance-sheet, it is reasonable to assume that the earnings between December 31st and March 31st have an effect upon the purchase price, and even though the transfer is made "as at" December 31st, it would be incorrect to include the earnings for the three months in consolidated earned surplus.

Where a negligible period intervenes between the "as at" date and the actual date of acquisition, it may be ignored for practical reasons. This should not, however, be regarded as modifying the principle generally applicable.

Where the circumstances do not justify treating the "as at" date as the acquisition date, the income and expenses of the subsidiary are often included in the consolidated income account for the full period and the portion of the subsidiary's net income applicable to the pre-acquisition period is then deducted in one amount before the transfer of the consolidated net income to consolidated earned surplus. This not only simplifies preparation of the statements but gives a better indication of earnings on a recurring basis.

In some cases modified statements are prepared, giving effect to the acquisition as at the beginning of the period of all companies acquired during the period. In such cases it is important to avoid the duplication of income which would result from the inclusion in the consolidated earnings of both (a) the earnings of a subsidiary for the period between the "as at" date and the actual date of acquisition and (b) the income derived by the parent company during the same period from the assets used to acquire the subsidiary's stock.

The United States treasury, for statutory reasons, has never recognized "as at" transactions for income-tax purposes. Subsidiary companies can be included in consolidated income-tax returns only from the date when actual ownership of the subsidiary's stock is acquired, unless the pre-acquisition period is less than thirty-one days.

FOREIGN SUBSIDIARIES

Affiliated groups which include foreign subsidiaries offer special problems, not so much because of the difficulty in stating abstract principles as because of the difficulty of practical application and the element of foreign exchange, especially if the currencies of a number of different countries are involved, particularly when there has been considerable fluctuation in exchange. When the foreign subsidiaries are actually consolidated with the accounts of the parent company, good practice calls for valuing the current assets and liabilities at the rate of exchange obtaining at or about the date of the balance-sheet. As to the fixed assets, however, the more general practice is to use the rate of exchange obtaining at the time of acquisition or construction of such assets.

There is also involved the matter of making provision for American taxes which would become payable if undivided profits of the foreign subsidiaries were brought to this country. The practice on this point is not entirely settled and the question is complicated by the fact that the transfer of profits may be deferred to subsequent years, and the rate of tax, or even the classes of taxes, applicable at that time can not now be definitely foreseen. There is also an offset against American income tax on the foreign profits transferred for foreign income tax paid thereon, though such offset is limited to the rate of American income tax payable on such profits. Still further, some of the profits may never be transferred, if they have been invested in plant or if the business has been so expanded that increased working capital is permanently required abroad. To the extent, however, that earnings would be available for transfer to America, and taxes would be payable thereon in excess of probable credits applicable to such transfers, the better practice is to provide for such taxes in preparing the consolidated income account and balance-sheet, or to indicate by a note that no provision has been made.

INTERCOMPANY SECURITY TRANSACTIONS

A question which must occasionally be dealt with is: When and how to adjust for premiums or discounts upon reacquisition of securities of the affiliated group, especially when the company acquiring them is not the issuing company. From the standpoint of a consolidated balance-sheet it would seem that the same general principles would govern the adjustments for premiums or discounts in transactions of this kind as apply in the case of a single company reacquiring its own securities. If bonds are acquired, with no intention of resale, the substance of the transaction is that a liability is being discharged. If the bonds have been purchased at a discount, the credit arising therefrom should first be applied to extinguish any unamortized bond discount or expense carried with respect to such securities. If the reacquisition discount exceeds such unamortized discount, the excess is a non-operating item of gain for the year and, if of unusual amount, it should be set out separately. It may even be desirable to credit the amount directly to earned surplus because of the special nature of the transaction.

If a premium of material amount has been paid on bonds acquired, it should be charged against the consolidated surplus; if not appreciable in amount, it may be charged against the current year's income account.

It has been argued that when a parent company acquires outstanding bonds of a subsidiary, any premium paid represents additional cost of the subsidiary to the parent company. This is based on the theory that it is immaterial whether all of the securities of the subsidiary are acquired at one time or at different times. The argument, however, does not appear sound. The consolidated balance-sheet prior to the purchase of the bonds disclosed certain assets and a liability for the face amount of the bonds. No new asset is acquired, and nothing is added to the value of the assets already owned by discharging the liability for a larger amount in advance of its due date.

Nor would it seem desirable, or even correct, to carry the premium and amortize it over the remaining life of the bonds, because from a consolidated standpoint cash has been withdrawn from the business to discharge the liability and the transaction is a closed one which should have no effect on future income accounts. There may be an exception when bonds are retired at a premium in order to issue new bonds at a lower interest rate. In such circumstances there is considerable justification for spreading the premium over the life of the new issue so that it will be charged against the periods benefited.

In the event that capital stock of either the parent company or of its subsidiaries is acquired, any profit thereon should be credited to capital surplus.* The New York stock exchange in its recent publications holds that a transaction in a company's own capital stock does not give rise to earned surplus. An exception would doubtless be conceded in a case where preferred stock has been sold at a discount and such discount was charged against earned surplus. Any discount realized on the reacquisition of such stock represents a recovery of the previous charge to earned surplus and to that extent is a proper credit thereto. In those cases where preferred stock is retired at a stipulated premium, the premium is in the nature of a supplemental dividend or compensation to the preferred stockholder for the use of his capital, and in such cases would properly be charged to earned surplus as in the case of ordinary dividends.

There is not as yet complete agreement with the position taken by the stock exchange that a profit on the purchase and sale by a corporation of its own stock in all circumstances represents capital surplus. When a company, either directly or through a subsidiary, actually trades in its own stock, it is difficult to distinguish between the trading profit so derived and a profit derived from trading in the stock of an unrelated company.

PLEDGE OF INTERCOMPANY SECURITIES

At a meeting of the Robert Morris Associates held within the past year, the question was raised whether in the case of a parent

* There may be circumstances in which the profit on reacquired capital stock, especially if originally issued for property other than cash, should be credited to some asset account rather than to surplus. See Montgomery's *Auditing Theory and Practice* (4th Ed.) page 244 et seq.

company having a bond issue outstanding, which is secured by the entire capital stock of one or more of the subsidiary companies whose accounts were included in the consolidated balance-sheet, it is required that the pledging of the subsidiary stocks should be indicated on the balance-sheet. In view of the fact that the accounts of the subsidiaries are consolidated with those of the parent company, the stocks of the subsidiary companies do not appear as such on the balance-sheet.

In considering this question, it should not be overlooked that consolidated balance-sheets do not usually purport to set forth the relative positions of different classes of creditors. Consolidated balance-sheets are not necessarily sufficient in themselves for credit purposes, and balance-sheets for some, if not all, of the separate corporations included in an affiliated or controlled group frequently need to be secured by the lender to supplement consolidated statements submitted to him. The general rule of the Federal Reserve bank of New York is that both a balance-sheet of the borrowing company and a consolidated statement, if the borrowing company is one of an affiliated group, are required. It is to be noted that several large public-utility corporations now publish both an unconsolidated balance-sheet of the parent company and a consolidated balance-sheet of the parent and its subsidiary and affiliated corporations. This has not yet, however, become general corporate practice.

A study of a number of balance-sheets, which showed mortgage and collateral note issues that were obviously secured by collateral, consisting of the stock and/or obligations of subsidiaries, indicated that at the present time it is not the practice to show on a balance-sheet the various collateral securing such issues. Bankers are on notice that if a collateral note issue appears among the liabilities on the consolidated balance-sheet, there is collateral, and that it may be composed of a great many items, including capital stock of subsidiary companies.

SALE OF SUBSIDIARY

When the stock of a subsidiary is sold during the year, it is proper to include in the consolidated income account the earnings of such subsidiary for the period during which it was a member of the affiliated group, but if the subsidiary is a substantial one, the financial statements should disclose the facts.

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 also have to be made for any dividends received by the parent from the subsidiary. There have been cases where an apparent loss was realized upon the sale of a subsidiary but, after adjusting the basis by the amount of the subsidiary's losses, a profit actually resulted from the sale. Under an inequitable feature of the present income-tax regulations relating to consolidated returns, the earnings of the subsidiary since acquisition can not be added to the tax basis, but in general the losses of the subsidiary must be deducted from the basis.

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.

PROVISION FOR MINORITY INTEREST IN EARNINGS

An affiliated group includes one subsidiary in which the parent company owns all of the cumulative preferred stock and 75 per cent. of the common stock. The subsidiary company, until last year, had consistently been showing losses and consequently dividends had not been paid on the preferred stock. In 1930, the subsidiary showed a substantial profit, and the question arose whether, in preparing the consolidated income account and the consolidated balance-sheet, any part of these profits should be allocated to the common-stock minority interests.

The common stockholders do not have any equity in the earnings until the earnings have reached an amount where they are sufficient to cover the accumulated dividends on the preferred stock. In a year in which the company made a profit in excess of the annual dividend on the preferred stock, but no part of the profit accrued to the common stock because of the unsatisfied claim of the preferred stock to cumulative dividends in prior years, the situation with respect to the consolidated income account is the same as though the parent company had owned none of the common stock but was receiving during the current year back dividends on its preferred holdings in addition to the current dividend. Where the collection of back dividends is a large enough item to affect materially the amount of the consolidated income, because no provision was made for the common-stock minority interest in profits, a proper memorandum might well be made on the statement. However, it would have to be a rather aggravated situation where the question would practically arise.

INTERCOMPANY PROFITS IN THE CASE OF PARTLY OWNED SUBSIDIARIES

When a portion of the stock of a subsidiary is not owned within the affiliated group, the proportionate part of any intercompany profit is earned and accrues to the minority stock outstanding. Consequently, the elimination of intercompany profit should be made only to the extent that the stock of the subsidiaries affected is owned within the group.

This point most often arises in relation to inventories. When the minority stock outstanding is small, this adjustment of the elimination may well be disregarded as the only effect of disregarding it is to reduce slightly the inventory (or other asset affected) and correspondingly the book value of the minority stock. Where, however, the minority interest outstanding is substantial, the adjustment referred to should be made.

It need hardly be mentioned that in making such an adjustment the amount of intercompany profit to be dealt with will be only the amount remaining in the inventory after applying the usual rule of "cost or market, whichever is lower." Further, "market" in such case is the replacement cost to the vendor affiliate and not to the vendee, and such replacement cost must also not be in excess of the prospective selling price.

INTERCOMPANY INVENTORY PROFITS AT DATE OF ACQUISITION

When companies become affiliated which have previously been doing business with each other the problem at times arises as to the treatment of their combined inventories in the initial consolidated balance-sheet. The point has added importance because of its bearing on the consolidated income account for the first fiscal period of the affiliated companies.

Let us assume that Company A, which has been doing business with Company B for a number of years but has heretofore had no financial interest in B, acquires the latter's capital stock.

Let us further assume that at the time of such acquisition B has in its inventory $100,000 of goods recently purchased from A and on the sale of which A had realized a gross profit of $20,000. The goods are in excellent condition, and had the two companies not become affiliated there would be no question whatever of their being worth fully $100,000 and of the profit of $20,000 having been fully earned by A. In the negotiations for the sale of the stock of B to A, the vendors naturally take the position that B has an asset which cost $100,000, which can not be replaced by B for less than that figure and in the ordinary course of business will realize the usual rate of profit thereon. Consequently, the vendors of B's stock insist that in fixing the price to be paid them the $100,000 of goods must be valued at that figure.

If, however, the goods referred to are included at $100,000 in the inventory in the initial consolidated balance-sheet, there will be a distortion of the operating income shown in the consolidated income account for the period immediately following affiliation. The intercompany profit at the close of that period will naturally be eliminated, and unless the $20,000 of profit paid to A by B on the $100,000 of goods included in the combined inventories at the date of affiliation is also eliminated from the opening inventory, the consolidated income will be understated by $20,000.

In effect, what happens is that the parent company A is accepting a return of $100,000 of goods which it had previously thought were definitely sold and are now coming back as an incident of the acquisition of the ownership of B. Assuming this as a premise, one procedure would be to charge the $20,000 against the surplus of A at the date it acquires the stock of B. The consolidated surplus would remain permanently reduced by this figure.

An alternative procedure would be to consider the $20,000 as part of the assets of B which are purchased by A through the acquisition of the stock of B, but to treat it as the cost of goodwill or other intangible asset. This would be on the theory that the acceptance of a return of the goods is a necessary condition of the acquisition of the stock of B, and the entire cost thereof is a capital investment, even though for a part of it, viz., $20,000, no tangible asset is received.

Although the first procedure outlined above is the more conservative of the two alternatives, the second seems to reflect more closely the actual situation and to be fully warranted in principle.

While the foregoing illustration has been based on the acquisition of the stock of one company by another, the principle would apply just as well to a case where two or more companies, which have been doing business with each other and have in their inventories goods acquired from each other, are consolidated through the acquisition of their stocks by a new holding company.