Journal of Accountancy

Volume 28 | Issue 4 Article 3

10-1919

Consolidated Accounts

George R. Webster

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation
Webster, George R. (1919) "Consolidated Accounts," *Journal of Accountancy*: Vol. 28: Iss. 4, Article 3.
Available at: https://egrove.olemiss.edu/jofa/vol28/iss4/3

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Consolidated Accounts*

By George R. Webster

The need for consolidated accounts practically started with the era of the holding company, although there were, of course, prior to that time many corporations which had formed subsidiary companies in order to comply with the requirements of state laws, and for other reasons. Probably the first important consolidated accounts to be published were those of the United States Steel Corporation in 1902.

The accounts of a corporation should be prepared so that the auditor can certify that the balance-sheet represents the true financial position of the company, and that the profit and loss account is a fair statement of the result of the company's operations. It has long been recognized by accountants that in the case of corporations with subsidiary companies these two conditions can only be shown by the preparation of consolidated accounts. If bankers had insisted on the preparation of such accounts they would probably have avoided several unpleasant experiences.

If advances are made by a holding company to a subsidiary company or if the subsidiary company borrows money or incurs outside liabilities these liabilities of the subsidiary company may be represented on its books by current assets, capital expenditure or even by losses or by a combination of these items, and it is only by consolidation that the true financial position of the companies can be shown. Cases have been known where the current liabilities of the holding company were almost negligible but where consolidated accounts showed current liabilities largely in excess of current assets.

It is also possible for holding companies to take into their profit and loss accounts dividends from such subsidiary companies as are making profits and to make no provision for losses made by other subsidiary companies. No accountant should, of course, certify such a statement without a qualification, but even

*A paper read at the annual meeting of the American Institute of Accountants, Cincinnati, Ohio, September 17, 1919.

if losses are provided for and the profit and loss account is correctly stated, the balance-sheet of the holding company does not show the true financial position of the holding company and its subsidiary companies. In several notorious cases balance-sheets of holding companies have been issued which did not show any contingent liability for endorsement of notes of subsidiary companies, although these amounted to very considerable sums. The consolidated accounts in such cases would, of course, have shown the obligations of the company and its subsidiary companies and the assets against them.

However, it is not necessary to discuss at length with accountants the need for consolidation. Those members of the institute who are not convinced on this point can refer to excellent papers on the subject by W. M. Lybrand and others as well as to standard text-books.

For a time many lawyers were opposed to the presentation of consolidated accounts by companies to their stockholders, but the leading lawyers engaged in corporation practice have long since recognized that the technical legal situation is less important to stockholders and the public than the substantial position and have accordingly accepted the principle of consolidated accounts.

The federal reserve board has taken occasion to point out to banks which are members of the system that they do not get an adequate view of the financial condition of a company which has subsidiaries unless they secure consolidated accounts.

The income-tax law and regulations now require the submission of consolidated returns under certain conditions. The development of this requirement is very interesting.

The English finance act of 1915 contained a provision for consolidation in the following terms:

> Where any company, either in its own name or that of a nominee, owns the whole of the ordinary capital of any other company carrying on the same trade or business or so much of that capital as under the general law a single shareholder can legally own, the provisions of part III of this act as to excess profits duty and the pre-war standard of profits shall apply as if that other company were a branch of the first-named company, and the profits of the two companies shall not be separately assessed.

Our revenue act of 1917 contained no mention of consolidated returns, but before the regulations were issued the American Institute of Accountants submitted a brief strongly advocating

consolidated returns. The brief was published in THE JOURNAL OF ACCOUNTANCY of January, 1919. The full brief should be carefully read, but the following excerpts may be quoted:

> If the rule which we advocate (consolidated returns) be adopted the tax will be based on the real facts and determined by the relation between true income and the true investment of the group of companies as a whole; and the latter course (consolidated returns) would impose no additional burdens on anyone, since it is the course followed for all practical purposes by the corporations themselves and recognized by bankers, economists and accountants as the only course which reveals the true situation.

The regulations subsequently issued provided that "whenever necessary to more equitably determine the invested capital or taxable income the commissioner of internal revenue *may* require corporations classified as affiliated under article 77 to furnish a consolidated return of net income and invested capital." Subsequently, a treasury decision was issued under which "affiliated corporations, as limited and defined in paragraphs C and D of the regulations *are hereby directed* to make consolidated returns for the purpose of excess profits tax." In these regulations it was stated:

> A. Two or more corporations are not "affiliated" merely because all or substantially all of the stock therein is owned by the same corporation, individual or partnership; they must also be engaged in the same or a closely related business.

Under the revenue law of 1918 consolidated returns were specifically mentioned in the act, which states that "corporations which are affiliated within the meaning of this section *shall*, under regulations to be prescribed by the commissioner . . . make a consolidated return of net income and invested capital." The act stated that two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interest, or by a nominee or nominees, substantially all the stock of the other or others; or (2) if substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. It will thus be seen that in the 1917 act no mention was made of consolidated returns but that the regulations provided for the consolidated returns of affiliated companies engaged in the same or closely related business, while the 1918 act specifically recognizes and calls for consolidated returns and makes the requisite the holding of all or substantially all the voting stock irrespective of whether the companies are engaged in similar businesses or not.

It may therefore be fairly said that the principle of consolidation has attained general acceptance. It may be well to mention, however, that a consolidated return for purposes of the revenue act may be a very different statement from the consolidated accounts prepared by the company for submission to its stockholders. The chief reasons for this difference are that for the revenue act foreign corporations are not brought into the consolidation and under the 1918 act companies organized after August 1, 1914, not successor to a then existing business, 50% of whose gross income was derived from government contracts made between April 6, 1917, and November 11, 1918, are not included. It might also happen that companies the stock of which was owned by another corporation to the extent of between 50 and 95%, might be consolidated in the statement submitted to stockholders but might be excluded in the statement prepared under the revenue act of 1918.

* * * * * *

The two principal points for consideration in regard to consolidated accounts are:

1—What companies should be consolidated.

2—How the consolidated account should be prepared.

What Companies Should be Consolidated

The regulations of the revenue act of 1918 provide that the owning or controlling of 95% or more of the outstanding voting capital stock shall be deemed to constitute an affiliation, but that consolidated returns may be required even though the stock ownership is less than 95%; and the regulations call for disclosure of affiliations where the stock ownership is in excess of 50%. Under the revenue act, therefore, consolidation is obligatory when 95% or more of the voting stock is owned and may be called for when the stock ownership is in excess of 50%.

This leaves a wide range of possibilities, but it is not believed that any definite percentage can be laid down and the question of whether the accounts of a company should be consolidated or not for the purpose of published statements is largely one of judgment, bearing in mind always that the object of the consolidated balance-sheet is to show the true financial position of

the company and its subsidiary companies. In doubtful or border-line cases the final test must be whether or not the true financial position is best shown by consolidation.

How the Consolidated Accounts Should be Prepared

Consolidated Balance-Sheet

The object of a consolidated balance-sheet is to show the true financial position of a company and its subsidiary companies with regard to the outside public; consequently all inter-company holdings of stock and all inter-company balances of every kind should be eliminated in the consolidated balance-sheet.

The most practical method of preparing a consolidated balance-sheet is to use analysis paper and then, depending on the number of companies and the number of accounts to be shown on the balance-sheet, either list the asset and liability accounts on the side with a column for each company or list the companies on the side and have a column for each asset and liability account. The balance-sheet for each company should then be entered on the sheets and totals made of each account. A column or line should then be provided for eliminations and adjustments, and then a column or line for the final consolidated figures.

All inter-company current accounts should be shown separately and should be reconciled and any differences allocated to the proper asset or liability account. Thus if, as in the example shown later, it is found that a difference exists in the current account between two companies because goods shipped by one company have not been received and taken up on the books of the other, an entry should be made crediting inter-company account and charging inventory, as it is clear that the goods are still in the inventory of the group. When all differences on the inter-company accounts have been adjusted the inter-company debits will equal the inter-company credits and both should be eliminated.

The next elimination to be made is that of the inter-company holdings of capital stocks.

It will frequently be found that the book value of the stock of a subsidiary company on the books of the holding company is different from the par value of the stock of the subsidiary company and this difference has to be adjusted.

Where the book value of a subsidiary company in a balance-sheet of the company holding that stock is in excess of the par value of the stock plus the surplus of the subsidiary company at the date of acquisition the excess should be charged to goodwill. Where the book value of the stock of a subsidiary company in a balance-sheet of the company holding that stock is less than the capital stock plus the surplus of the subsidiary company at date of acquisition, the difference should be credited to capital surplus, unless there is goodwill of a greater amount either on the accounts of the holding company or of the subsidiary company, or if there is goodwill of a greater amount arising from purchases of stocks of other subsidiary companies. This treatment is based on the assumption that goodwill is shown separately, but many companies in their published accounts do not show goodwill separately and simply have an account called "cost of properties." In this case the debits and credits would be made to this account instead of to goodwill or capital surplus.

Objections have frequently been made to the elimination of the surplus of the subsidiary company at date of acquisition, and claim has been made that this surplus should form part of the consolidated surplus; but it seems to be clear that when a company buys the stock of another company it also purchases the surplus accumulated to the date of purchase, and consequently the surplus at date of acquisition should in consolidation be treated in the same way as the capital stock. If any dividends are received out of that surplus they should be credited to the cost of the investment on the books of the holding company.

By applying to consolidated accounts the principle that a company cannot make profits before it has begun business, we reach the conclusion that the profit and loss account of a parent or holding company should reflect only the profits of that company from its inception together with the profits of subsidiary companies from the dates of their acquisition.

Where one corporation does not own the whole of the capital stock of a subsidiary company, but where the accounts are to be consolidated, the amount to be eliminated should be the par value of the stock of the subsidiary company owned by the company and the proportion of the surplus at date of acquisition applicable to the stock owned. When this amount has been

eliminated with the corresponding debit or credit to goodwill or to capital surplus, it will leave the par value of the stock of the subsidiary company in the hands of the public and the pro rata share of the surplus at date of acquisition, which together with the proportion of the surplus since acquisition should be shown on the balance-sheet as capital stock of subsidiary companies in hands of public at book value. Subsequent earnings of the subsidiary company should be divided according to the stock owned by the parent company and that in the hands of the public—the proportion applicable to the stock of the parent company being taken into the profit and loss account of that company and the proportion applicable to the stock in the hands of the public being added to the book value of the stock in the hands of the public.

Some corporations have not followed this method but have taken up in the consolidated assets and liabilities the proportion of each asset and liability applicable to the stock owned. It is not believed that this is the best technique, nor that it is the best method of showing the financial position of the consolidated companies. If one company owns 90% of the stock of another company, the inclusion of 90% of the plant and other assets and 90% of the liabilities of the subsidiary company does not really show the true position; and it seems more reasonable to assume that all the assets and all the liabilities belong to the consolidated group with a liability to outsiders of the value of the stock owned by them.

The method of taking up a proportion of the assets and liabilities also gives rise to some rather peculiar results in inter-company accounts. For example, if the parent company has an account receivable of $1,000 against the subsidiary company (say 90% owned) and the subsidiary company a corresponding liability to the parent company, then if the percentage of the assets and liabilities of the subsidiary company is taken this would result in showing the inter-company item as only $900.00 in the subsidiary company's liabilities against the $1,000.00 on the parent company, and it would, therefore, be necessary to treat $100.00 as an account receivable from outsiders in the consolidated statement.

Another item which requires careful investigation in consolidated accounts is that of inventories. If the various companies in a consolidation buy or sell from one another and if these transactions are not put through at cost, the inventories of some of the companies will contain inter-company profit. As the object of the consolidated balance-sheet is to show the financial position of the group as a unit this would be equivalent to a single company's taking up inventories at a valuation higher than cost.

In these cases the inter-company profit in the inventory both at the beginning and end of the period should be ascertained and entries made charging surplus at the beginning of the period with the inter-company profit at the beginning of the period, crediting inventories with the inter-company profit at the end of the period and charging or crediting the profits of the year with the increase or decrease of the inter-company profit in the inventories at end of the year compared with that at the beginning of the year.

It frequently happens that there may be within a group control of other corporations which are not consolidated on account of the holdings being perhaps a bare majority of the stock. It is largely a matter of judgment whether or not the group's proportion of the earnings of these controlled companies should be taken into the accounts of the group. Certainly where there is a control which is not exercised it would not appear that the proportion of the earnings of the controlled company should be taken up, but that only dividends actually received should be credited to profit and loss. Where, however, control is exercised, there seems no reason why the proportion of profits or losses of the controlled company should not be taken into the accounts. The entry to be made on the books of the holding company would be to charge undivided profits of controlled companies—which in the published accounts might be added to the investment in controlled companies—and credit profit and loss. As dividends are received cash will be debited and undivided profits of controlled companies credited.

In certain cases where investments in controlled companies represent a substantial portion of the assets of a company, it is

WORK SHEET FOR CONSOLIDATED BALANCE-SHEET

ASSETS

	A	B	C		Eliminations and adjustments	Consolidated
Properties	$1,000,000.00	$100,000.00	$200,000.00			$1,300,000.00
Less—Depreciation	100,000.00	10,000.00	20,000.00			130,000.00
	$900,000.00	$90,000.00	$180,000.00			$1,170,000.00
				(1)	**$19,750.00**	
Goodwill	250,000.00	50,000.00		(5)	50,000.00	330,250.00
Investments in stocks of subsidiary companies:						
B (par value $ 95,000)	80,000.00			(1)	**80,000.00**	
C (par value $100,000)	175,000.00			(5)	**175,000.00**	
Inventories	220,000.00	100,000.00	75,000.00	(6)	5,000.00	390,000.00
				(8)	**10,000.00**	
Accounts receivable	175,000.00	50,000.00				225,000.00
Cash	150,000.00	10,000.00	20,000.00	(7)	5,000.00	185,000.00
Deferred charges	25,000.00					25,000.00
Inter-company accounts	100,000.00	**85,000.00**	**5,000.00**	(6)	**5,000.00**	
				(7)	**5,000.00**	
	$2,075,000.00	$215,000.00	$270,000.00		**$234,750.00**	$2,325,250.00

LIABILITIES

	A	B	C		Eliminations and adjustments	Consolidated
Capital stock	$1,000,000.00	$100,000.00	$100,000.00	(1)	**$95,000.00**	
				(2)	**5,000.00**	
				(5)	**100,000.00**	$1,000,000.00
Capital stock of subsidiary companies in hands of public at book value				(2)	5,000.00	
				(3)	250.00	
				(4)	250.00	5,500.00
Bonds	500,000.00					500,000.00
Bills payable	100,000.00	30,000.00				130,000.00
Accounts payable	50,000.00	75,000.00	70,000.00			195,000.00
Surplus	425,000.00	10,000.00	100,000.00	(1)	**4,750.00**	
				(3)	**250.00**	
				(4)	**250.00**	
				(5)	**25,000.00**	
				(8)	**10,000.00**	494,750.00
	$2,075,000.00	$215,000.00	$270,000.00		**$234,750.00**	$2,325,250.00

WORK SHEET FOR SURPLUS ACCOUNT

	A	B	C	Eliminations and adjustments	Consolidated
Surplus of subsidiary companies prior to acquisition by holding company		$5,000.00	$25,000.00	(1) $4,750.00 (3) 250.00 (5) 25,000.00	
Surplus at beginning of year—A	$300,000.00			(9) 7,500.00	
Surplus of subsidiary companies from date of acquisition to beginning of year		2,500.00	100,000.00	(4) 125.00	$394,875.00
Profit for year, excluding dividends from subsidiary companies	65,500.00	12,500.00	75,000.00	(8) 10,000.00 (7) 7,500.00 (4) 625.00	149,875.00
Inter-company dividends	109,500.00	10,000.00	100,000.00	(4) 500.00	
Dividends paid by holding company	50,000.00				50,000.00
Surplus at end of year	$425,000.00	$10,000.00	$100,000.00		$494,750.00

desirable to furnish, with the holding company's balance-sheet and profit and loss account, balance-sheets and profit and loss accounts of the controlled companies.

Profit and Loss

The profit and loss account of a parent company alone would show the profits from its own operations together with dividends received from subsidiary companies, but the earnings of the parent company and its subsidiary companies can only be shown correctly by taking into account the profits or losses of the parent company and each subsidiary company irrespective of whether dividends have been declared or not.

In preparing the consolidated profit and loss account the same principle of eliminating all inter-company transactions should, of course, be followed.

Example of a Simple Consolidated Balance-sheet

In order to illustrate the method of consolidation a simple example may be taken. (The figures used for the various assets and liabilities are not taken with any regard to the relative proportions that might be expected in actual experience.)

We will assume:

That the parent company A, which is also an operating company, owns 95% of the stock of B and 100% of the stock of C;

That B and C each have a capital of $100,000;

That the 95% of the stock of B stands on the books of A at $80,000;

That the 100% stock of C stands on the books of A at $175,000;

That the surplus of B at date of acquisition was $5,000 and the surplus of C at date of acquisition $25,000.

We will first eliminate the investment of A in B and C and the capital stock of B and C owned by A.

The book value of the stock of B at date of acquisition by A is $105,000 ($100,000 stock and $5,000 surplus). Ninety-five per cent. thereof is $99,750. The value on the books of A is $80,000 and there must therefore be a credit to goodwill of $19,750 (entry No. 1). This leaves the $5,000 stock of B not owned by A which by entry No. 2 is transferred to capital stock

of subsidiary companies in hands of public at book value, so as to show separately the outstanding capital stock of the parent company and the stock of the subsidiary companies not owned. Of the surplus of B at date of acquisition there is left $250, the proportion of the surplus at that date applicable to the stock in hands of the public, and this is transferred from surplus to stock of subsidiary companies in hands of public at book value by entry No. 3. The surplus account of B at the date of the balance-sheet still contains the proportion of the surplus since date of acquisition applicable to the stock in the hands of the public, and this is transferred by entry No. 4.

In the case of the stock of C, all the stock is owned by A, and consequently only one entry is necessary. The book value of the stock of C at date of acquisition is $125,000 and it is carried on the books of A at $175,000 and it is necessary therefore to debit goodwill with $50,000 in eliminating these items (entry No. 5).

The balance-sheets show that the inter-company accounts are not in agreement and investigation shows that the difference arises because a shipment of goods made by one company and valued at $5,000 had not been received or taken up by the receiving company, and that a remittance of $5,000 made by one company had not been received by the other company. These are adjusted by entries No. 6 and No. 7, charging inventories and cash and crediting inter-company accounts.

In the example taken, one of the companies sells to another and allowance has therefore to be made for inter-company profit in the inventories, and this has been eliminated by entry No. 8.

By extending the various items into the consolidated column the consolidated balance-sheet is obtained. In this balance-sheet, however, the surplus account is shown in one item, and, in order to show the surplus at the beginning of the year, the profits for the year, dividends paid and surplus at the end of the year, a separate sheet has been used, although this detail can if desired be shown on the balance-sheet.

In making the eliminating and adjusting entries for the surplus analysis sheet, the debits and credits to surplus on the balance-sheet have to be applied to the various items in the surplus analysis. In the example taken, all the entries can be readily

applied to the proper items, with the exception of the debit of $250 in entry No. 4, for the proportion applicable to the stock in the hands of the public of the surplus of B since acquisition by A. This is divided as follows:

Surplus from date of acquisition to beginning of year, 5% of $2,500	$125.00
Proportion of profits for year, 5% of $12,500	625.00
	$750.00
Less—Proportion of dividend, 5% of $10,000	$500.00
	$250.00

All the entries on the balance-sheet having been made there still remain to be made entries for any items made at the end of the previous year not taken up on the books of any of the companies. In this case an entry would be necessary for the inter-company profit in inventories at the beginning of the year. We have assumed that this amounted to $7,500, and consequently make an entry debiting surplus at beginning of the year and crediting profits for the year with this amount.

The entries for inter-company profits in the inventory are only necessary where goods are not transferred at cost and where each company values its inventory at cost as billed to it. Where inventories are reduced to net integration cost before being taken up on the books of the various companies these entries are not necessary.

Eliminating and Adjusting Entries

No. 1

Capital stock (of B owned by A),	Dr. $95,000.00	
Surplus (surplus of B at date of acquisition by A, applicable to stock owned by A),	4,750.00	
To investment in stock of B (cost on books of A),		$80,000.00

Goodwill (difference between par value plus surplus at date of acquisition and cost to A),			19,750.00
No. 2			
Capital stock of B,	Dr.	5,000.00	
To capital stock of subsidiary companies in hands of public at book value,			5,000.00
Par value of B capital stock in hands of public.			
No. 3			
Surplus,	Dr.	250.00	
To capital stock of subsidiary companies in hands of public at book value,			250.00
Proportion of surplus of B at date of acquisition applicable to stock in hands of public.			
No. 4			
Surplus,	Dr.	250.00	
To capital stock of subsidiary companies in hands of public at book value,			250.00
Proportion of surplus of B since date of acquisition applicable to stock in hands of public.			
No. 5			
Capital stock (of C owned by A),	Dr.	$100,000.00	
Surplus (surplus of C at date of acquisition by A),		25,000.00	
Goodwill (difference between cost and par value and surplus at date of acquisition of stock of C owned by A),		50,000.00	
To investment in stock of C (cost to A)			$175,000.00

No. 6

Inventories,	Dr.	5,000.00	
To inter-company accounts, Shipment by A to B taken up by B.			5,000.00

No. 7

Cash,	Dr.	5,000.00	
To inter-company accounts, Cash in transit remitted by C to B not received by B.			5,000.00

No. 8

Surplus,	Dr.	10,000.00	
To inventories, Inter-company profit in inventories at end of year.			10,000.00

No. 9

Surplus,	Dr.	7,500.00	
To surplus, For inter-company profits in inventories at beginning of year.			7,500.00