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Mutual Stockholdings in Consolidated Statements

BY MAURICE MOONITZ

ALTHOUGH the material available on consolidated statements is inconsistent in many ways, there is at least a great deal of discussion on difficult points, together with arguments pro and con regarding conditions which seem to permit of alternative procedures.

However, on one important point, there seems to be unanimity in the solutions offered, and yet these solutions seem to be based upon a fallacy. This situation is the one in which there are mutual holdings of capital stock. The following example will illustrate this situation:

COMPANY A

Sundry assets	$100,000	Liabilities	$ 75,000
Investment in Company B (75 per cent int.)	75,000	Capital stock	100,000
	$175,000		$175,000

COMPANY B

Sundry assets	$ 25,000	Capital stock	$100,000
Investment in Company A (75 per cent int.)	75,000		
	$100,000		$100,000

Here we have Company A owning shares in Company B, and Company B owning shares in Company A. Considering Company A as a separate entity, we can say that its assets consist of sundry assets of $100,000 and an investment in the net worth of Company B valued at $75,000. Likewise, in the case of Company B, its assets consist of sundry assets of $25,000, and an investment in Company A valued at $75,000. But, when the two statements of A and B are considered together, the investment accounts begin to look suspiciously like treasury stock. If A and B should exchange their holdings of stock, we would ordinarily expect no change in the net worth of either, since assets of $75,000 were being parted with for other assets of the same value. But note what happens:

On A's books:		
Capital stock, Company A	$75,000	
Investment in Company B		$75,000
On B's books:		
Capital stock, Company B	$75,000	
Investment in Company A		$75,000

Here are their balance-sheets after the trade:

COMPANY A

Sundry assets	$100,000	Liabilities		$ 75,000
		Capital stock:		
		Issued	$100,000	
		Treasury stock	75,000	25,000
	$100,000			$100,000

Company B

Sundry assets	$ 25,000	Capital stock:		
		Issued	$100,000	
		Treasury stock	75,000	$ 25,000
	$ 25,000			$ 25,000

Presumably, we have exchanged value for value, and yet each company shows a decline in net worth of $75,000! This is clearly impossible. The net worth of each company was $25,000 before the exchange took place, and it was $25,000 after the exchange took place. The decline took place at the moment when each company held the shares of the other. This is the fact that has been overlooked by the various writers in their solutions to problems involving mutual holdings, although there have been a few references to it in their discussions.

In order to make the situation clear, let us make an assumption regarding two companies and their shareholdings:

Company M

Invested in Co. N	$100,000
Capital stock	100,000

Company N

Invested in Co. M	$100,000
Capital stock	100,000

Here we have complete interownership. No one will deny that the net result of the above situation is that neither company owns anything, or that the shares of each are worth exactly zero. To present the balance-sheet of Company M without the balance-sheet of Company N would be a presentation of a false statement, since it would show the net worth of Company M equal to $100,000, when actually it is equal to zero. Why, then, should there be a change in treatment when the mutual holdings are less than one hundred per cent? And yet, that is exactly what is done if we follow the solutions presented. The mutual shares held are treated just as any other shares issued and outstanding, and not as treasury shares.

This similarity to treasury stock was noted at least as long ago as 1902, in the case of *Robotham, et al.* v. *Prudential Insurance Company of America, et al.*[1] The facts in this case are interesting and will bear repetition here. Two companies were involved: Prudential, and Fidelity Trust. The stockholders of Prudential agreed to sell, pro rata, to Fidelity enough shares to give Fidelity fifty per cent plus one share of Prudential stock. In order to complete the transaction, Fidelity was to issue additional shares and the directors of Prudential were to take a substantial block of this new issue, enough, when added to existing holdings, to give Prudential a majority of the shares of Fidelity. Thus, each company would hold a majority of the shares of the other, with Prudential as the dominant company. This dominance would be effected by having Fidelity hold its election of directors first. These directors would, of course, be chosen by Prudential, so that when its own election was held, the directors it had appointed would choose Prudential directors thus creating a self-perpetuating syndicate. The extra-group shareholders would thus be completely squeezed out of any voice in the management.

Stevenson, vice chancellor, said:

"As will appear more fully hereafter, the proposed exchange of majority holdings of stock by these two corporations is in effect a retirement of a large part of the combined capital. When the scheme is effected, the remaining stockholders

[1] 53 Atl. 842; 64 N. J. Eq. 673.

of the Prudential Company are legal stockholders in their own company, and in equity are stockholders of the Fidelity Company, and the converse of this proposition is true of the Fidelity stockholders. In using this language, corporate existence is disregarded as a mere fiction. In fact, we have the management of the property and business of the remaining stockholders perpetually vested in the self-perpetuating syndicate . . .

"An illustration suggested . . . was as follows: Suppose ten corporations, each with the capacity to buy stock, be ranged in line. The first acquires a majority of the stock of the second, the second of the third, the third of the fourth, and so on to the end of the line. Last of all, the tenth corporation acquires a majority of the stock of the first . . . To heighten the color of the picture without affecting its legal aspects, it may be supposed that the perpetual syndicate who control the ten corporations sell all their stock but the necessary qualifying shares. Counsel for the defendants, with great courage and frankness, declared that the actual equitable owners of every dollar of the capital of these ten corporations, excepting the insignificant amount represented by the qualifying shares of the sydicate, would be powerless, under the laws of New Jersey, to get at their property, or in any way control its administration. And all this most amazing result is reached by construing the enabling act comprising section 61 of our general corporation law as establishing an absolute and arbitrary right in all corporations to purchase and hold stock in other corporations, and vote thereon, together with the rigid maintenance of the pure fiction of corporate existence, so as to make these fictitious creatures the actual owners of the stock which in equity belongs to their shareholders . . .

"When each of two corporations . . . acquires a majority of the stock of the other, what takes place, as I have said before, is in effect a retirement of a majority of the aggregate stock. Assuming that the selling stockholders have been paid the actual value or book value of their holdings, the combined capital and surplus of the two corporations have been diminished by the loss of the greater part thereof, say fifty-one per cent, which the selling stockholders have carried off in their pockets. The two corporations continue to do their business with forty-nine per cent of the original aggregate capital and surplus, and this capital and surplus is owned by the remaining stockholders of the two corporations, respectively. Each set of stockholders now own in equity a little less than a quarter of the original capital and surplus of their own corporation and a little more than a quarter of the original capital and surplus of the other corporation. Keeping alive fifty-one per cent of practically retired stock of each corporation as something owned by the other corporation in each case, as a fictitious person, is necessary for the purpose of bookkeeping, and for the equitable distribution of profits, and finally of capital. If the cross-purchases of stock between the two corporations continued indefinitely, the final result would be the distribution of the entire capital and surplus of each corporation, except what belonged to the qualifying shares of the directors. The result would be the same if each corporation paid out its capital and surplus for the retirement of all of its own stock except such qualifying shares. . . . The whole scheme is built upon fictions which our law maintains as necessary and valuable for many purposes, but which equity nowadays frequently casts aside for the prevention of fraud and the accomplishment of justice."

W. A. Staub gives this type of situation passing mention:

"Occasionally, a subsidiary will be found to own some of the parent company's stock. Here, too, an elimination is to be made of the intercompany holding, the parent company's stock in the consolidated balance-sheet being shown after deduction of that portion held by the subsidiary. The effect is just the same as though the parent company had purchased some of its own stock for its treasury. Consequently, any premium paid for such stock would be chargeable against the consolidated surplus."[2] No illustration is given, hence there is no way of telling whether Staub really appreciates what he has said.

Lewis A. Carman writes:[3]

"Unless the intercompany holdings are so small as to be negligible, the balance-sheets of members of a bilateral (or multilateral) group should never be published individually. The effect is precisely the same as though a company should conceal treasury stock under the caption 'Investments,' an overstatement of net worth."

Yet despite this clear recognition of what the situation is, Carman proceeds in his solutions to ignore the fact that these intercompany holdings have the same effect as treasury shares.[4]

The Accountant presents the following extreme example:[5] Company A used ninety per cent of the proceeds from the sale of its capital stock to form a subsidiary, which uses all ninety per cent to purchase shares of Company A from the public. Company B, the subsidiary, has no assets other than Company A stock, and no liabilities. Some additional facts are then given, and a solution asked for. The pertinent parts here are the comments:

"On consideration of the extreme figures stated in our illustration, it seems clear that the public should have the whole of the trading profit, but the cross-holding prevents this result. Such an arrangement, though apparently legal, seems to defeat the principle of company law which forbids reduction of capital.

"Surely in the example given . . . the parent company is reducing its capital in a manner contrary to the companies act, in as much as it is doing so without the sanction of the court; as a company is not allowed to purchase its own shares for that reason, it seems that it would not be allowed to do so through the medium of a subsidiary company, as the effect would be precisely the same."[6]

Of course, the question of legality is a purely secondary matter for our purpose. The important thing is: What is its effect, once it has been done?

THE JOURNAL OF ACCOUNTANCY for January, 1935,[7] contained a discussion of the situation in which Corporation A controlled, through complete ownership, a subsidiary Company B. Company B carries among its assets some of the shares of A. The question arose as to the treatment of such an item on the two balance-sheets. The discussion stated that such a situation amounted to a purchase of treasury shares by Corporation A through the medium of its subsidiary. No discussion was presented, however, on other phases of the matter, such as the handling of such shares on a subsequent consolidated balance-sheet.

In the case of such mutual shareholdings, the effect is the same as that which would obtain in a single corporation if treasury shares were allowed voting rights, and these rights were exercised by the directors. As soon as the number of treasury shares outnumbered the outside shares, then the "self-perpetuating syndicate" would be in a legally unassailable position, whether they held a few or many shares in their own

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[2] "Consolidated Financial Statements." *The Accountant*, Dec. 7, 1929, p. 737.

[3] "Intercorporate Relationships." *American Accountant*, April, 1932, p. 106.

[4] Mr. Carman, in a personal letter, denies that he has overlooked the point at issue in his solutions. However, I believe his solutions erroneous because they are based on the "simultaneous equation" method.

[5] April 29, 1933; p. 566.

[6] The point raised here regarding legality is discussed by W. H. Chantrey, F.C.A., in *The Accountant* for April 22, 1933, p. 533. He says, in part: "It would appear to be quite legal for a subsidiary company, the whole of whose capital is held by a holding company, to purchase shares of the holding company without any limit . . . provided that the holding company did not contravene this section (companies act, 1929, section 45) by giving financial assistance in connection with the purchase."

[7] Accounting Questions department, p. 73.

names. Such a situation would be intolerable, and is today impossible because treasury shares have no voting rights or rights to participation in dividends. Yet, where the same situation can arise through the mechanism of subsidiary companies, there do not seem to be any legal grounds (as yet) for preventing it.

There are certain indications, however, that the situation may be clarified by the courts in the near future. The case cited earlier (*Robotham* v. *Prudential*) dealt with this situation, but the decision itself hinged on another point arising under the special statutes regulating insurance companies. The vice chancellor did not say that corporations, in general, could not hold each other's stock, even though he recognized just what the effect was.

Until the courts (and legislatures) conceive of these affiliated concerns as an entity, as the accountant does when preparing consolidated statements, there can, of course, be no expectation that mutual holdings will be recognized as equivalent to treasury stock. There have been a few cases in which the corporate-entity concept has been swept aside.[8] In *Industrial Research Corp.* v. *General Motors Corporation* [9] the court held: ". . . the fiction of corporate entity may be disregarded where one corporation is so organized and controlled and its affairs are so conducted that it is, in fact, a mere instrumentality or adjunct of another corporation." This would seem to cover the case in which the subsidiary used its assets to purchase holding-company stock under direct order from the parent company, but it is doubtful if it would cover the case where the subsidiary acquired parent-company stock on its own initiative.

In another case, *Hart Steel Co.* v. *Railroad Supply Co.*,[10] it was held that a decision in a patent suit against a *wholly owned* subsidiary was *res judicata* as against the parent on the ground that there was a *complete* identity of interest.[11]

However, the general rule still seems strongly in favor of regarding each corporation as a distinct entity. In *Majestic Co.* v. *Orpheum Circuit Inc.*[12] the following points are made:

"In legal conception, a corporation has an entity separate and distinct from its stockholders; and the act of the corporation is not that of the stockholders. Nor is its obligation that of its stockholder . . .

"A corporation is not liable for the acts or the obligations of another corporation, *merely because it controls such other* by reason of ownership of its stock . . .

"The corporate entity will not be ignored at law nor in equity, whether the control is in the hands of one or many stockholders . . .

"The corporation will be regarded as a legal entity as a general rule, and the courts acting cautiously and only when the circumstances justify it, will ignore the fiction of a corporate entity, where it is used as a blind or instrumentality to defeat public convenience, justify wrong, or perpetuate a fraud, and will regard the corporation as an association of persons . . ."

What is the result of this identification of mutual stockholdings with treasury stock?

1. Since treasury stock possesses no voting rights or right of participation in dividends, only those shares not mutually held can be considered

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[8] For a complete treatment of this point, up to 1931, see W. H. Anderson, *Limitations of the Corporate Entity* (St. Louis, 1931).

[9] 29 F (2d) 623 Killits, D. J.

[10] 244 U. S. 294 (1917).

[11] On this same general topic see: *Gulf Oil Co.* v. *Llewellyn*, 248 U. S. 71 (1918) a tax case. *Chicago, etc. Ry.* v. *Minneapolis Civic Ass'n.* 247 U. S. 490 (1918) in which subsidiary and parent are treated as one in regard to rates.
S. P. Co. v. *Lowe*, 247 U. S. 330 (1918).

[12] 21 F (2d) 720 (1927).

as representing shares of ownership in the companies involved.

2. As a corollary to (1), only shares not mutually held can be allocated any shares of changes in net worth. This is the accounting problem, which is pertinent to the present discussion.

The conventional treatment, where mutual stockholdings are present, has been as follows:

COMPANY A—December 31, 1930

Sundry assets	$ 50,000	Capital stock	$ 75,000
Invest. in Co. B (at cost)	50,000	Surplus	25,000
	$100,000		$100,000

COMPANY B—December 31, 1930

Sundry assets	$ 47,000	Capital stock	$ 60,000
Invest. in A (at cost)	25,000	Surplus	12,000
	$ 72,000		$ 72,000

The intercompany holdings were both acquired on January 1, 1930, at book value. At that date, there was no surplus or deficit on either company's books. The solution would run as follows:

The true net worth of Company A is dependent in part on its share of the increase in net worth of Company B. Company B's true net worth is dependent in part on its share of the increase in Company A's net worth. We have two interdependent variables, hence we must resort to simultaneous equations for a solution:

Let x equal true net worth of Company A;
And y equal true net worth of Company B.
Then

(1) $x = 50{,}000 \text{ plus } \frac{5}{6}y$
(2) $y = 47{,}000 \text{ plus } \frac{1}{3}x$

(2) $3y = 141{,}000 \text{ plus } x$
(1) $\frac{5}{6}y = -50{,}000 \text{ plus } x$

Subtract: $\frac{13y}{6} = 191{,}000$

$y = \$\ 88{,}153.85$ (true net worth of B)
$x = 123{,}461.55$ (true net worth of A)

Calculation of extra-group interest in Company B:

Company A holds five-sixths of the shares of Company B, therefore the extra-group interest is equal to one-sixth of Company B's true net worth:

One-sixth of 88,153.85 = $14,692.31

This would be reflected in the consolidated balance-sheet thus:

Extra-group interest in Co. B:		
Capital stock at par	$10,000.00	
Surplus	4,692.31	$14,692.31

Treating the mutual holdings as treasury stock, the solution would be as follows:

COMPANY A—Revised Balance-sheet

Sundry assets	$ 50,000	Capital stock:		
Invest. in Co. B (cost)	25,000	Issued	$75,000	
		Held by B	25,000	$50,000
		Surplus		25,000
	$75,000			$75,000

COMPANY B—Revised Balance-sheet

Sundry assets	$47,000	Capital stock:		
		Issued	$60,000	
		Held by A	25,000	$35,000
		Surplus		12,000
	$47,000			$47.000

With the balance-sheet in this form, the solution is obvious. Company A should take up its share of the increase in B's net worth (twenty-five thirty-fifths of $12,000 equals $8,571.43), and the extra-group interest in Company B would be shown as ten thirty-fifths of $47,000 or $13,428.57, which would be reflected on the consolidated balance-sheet thus:

Extra-group interest in Co. B:		
Capital stock at par	$10,000.00	
Surplus	3,428.57	$13,428.57

That the difference in the results obtained by these two solutions is significant can readily be seen. More important than the change in value amounts attributable to the interests involved is the change in their relative strength. Under the first solution, the extra-group interest is equal to one-sixth of B's net worth; under the second solution, the interest is two-sevenths, almost double the proportion in the first solution. It might very well be in some instances that the extra-group stockholders would be thrown into the position of the dominant group through the elimination of mutual holdings as treasury stock.

There is, of course, a fallacy in the use of the simultaneous-equation method. This fallacy is the implicit assumption that the mutually held shares are shares which are fully issued and outstanding, and hence share in all changes in net worth. In a way it is too bad that there is this fallacy inherent in the procedure, because simultaneous equations could be powerful tools for solving complex situations with reference to intercompany holdings of stock.[13] There are several cases where the two methods yield identical results, hence simultaneous equations can be used in such situations. One case is that in which the consolidated balance-sheet is being prepared at date of acquisition, provided shares are acquired at book value. Of course, theoretically, all mutually held shares would have to be acquired on the same date, but if these holdings were acquired within a short period of each other, then as a practical matter they could be treated as though acquired on the same date. The reason for the fact that simultaneous equations can be used (and produce the same results) as of date of acquisition of mutual shareholdings is that there has been no opportunity for any change in total net worth to take place, hence no question as to the proper allocation of change. An example is shown at the top of page 234.

Another case in which the two methods yield identical results is that in which there is complete (one hundred per cent) ownership within the affiliation. Thus, Company A may own one hundred per cent of the shares of Companies B and C, or Company A may own eighty per cent of the shares of B and C, and B and C each own twenty per cent of each other's shares. In addition to these holdings, B and C also own shares in A. In a situation of this sort,

[13] Lewis A. Carman has an interesting series of articles on this in the *American Accountant:*
April, 1932, pp. 103–8;
May, 1932, pp. 140–2;
June, 1932, pp. 171–7;
July, 1932, pp. 204–12.

COMPANY A

Sundry assets	$100,000	Liabilities	$ 75,000
Invest. in B	75,000	Capital stock	100,000
	$175,000		$175,000

COMPANY B

Sundry assets	$ 75,000	Capital stock	$100,000
Invest. in A	25,000		
	$100,000		$100,000

Method I—Simultaneous Equations:

x = N. W. of Co. A
y = N. W. of Co. B

(1) $x = 25{,}000 \text{ plus } \frac{3}{4}y$
(2) $y = 75{,}000 \text{ plus } \frac{1}{4}x$

(2) $4 \times 4y = 300{,}000 \text{ plus } x$
$\frac{3}{4}y = -25{,}000 \text{ plus } x$

Subtract: $15\frac{1}{4}y = 325{,}000$
$y = 100{,}000$ (true net worth of Company B)
$x = 100{,}000$ (true net worth of Company A)

Extra-group interest in Company B would then be equal to one-quarter of $100,000 or $25,000.

Method II—Eliminate Mutual Holdings as Treasury Shares:

$25,000 worth of stock is the amount mutually held, hence capital stock figure of each is reduced to $75,000. The extra-group interest in Company B would then be equal to one-third of $75,000 or $25,000.

there is no extra-group interest present, hence there is no danger of miscalculating its share in net worth.

In any case in which there is a change in net worth to be allocated to controlling and extra-group interests, the simultaneous-equation method of solution yields a result which differs from the result obtained by considering mutual holdings as equivalent to treasury shares.

The examples used thus far in this chapter have all assumed that shares were acquired at book value, and also that they were acquired simultaneously. The procedure under such special conditions is fairly simple and obvious. The handling of cases in which shares were acquired at other than book value, or not simultaneously, requires a word of explanation.

The critical point in problems of this sort is the date on which the mutual shareholdings became effective. As of this date, the mutually held shares must be eliminated against the book value of the shares as outstanding. Any difference between book value and cost will then be treated just as premium or discount on treasury stock would be handled on the books of a single independent company, that is, by an adjustment to some surplus account (in this case, to consolidated surplus).

EXAMPLE:

Company A acquires seventy-five per cent of the shares of B on January 1st, at book value. Immediately after acquisition, the balance-sheets were as follows:

COMPANY A

Assets	$ 75,000	Capital stock	$100,000
Invest. in B (75%)	37,500	Surplus	12,500
	$112,500		$112,500

COMPANY B

Assets	$ 50,000	Capital stock	$20,000
		Surplus	30,000
	$ 50,000		$ 50,000

Six months later.

COMPANY A

Assets	$ 85,000	Capital stock	$100,000
Invest. in B (75%)	48,750	Surplus	33,750
	$133,750		$133,750

COMPANY B

Assets	$ 65,000	Capital stock	$ 20,000
		Surplus	45,000
	$ 65,000		$ 65,000

The next day, Company B acquires ten per cent of the shares of Company A, paying $13,000 cash for them. The book value of these shares is $13,375, therefore there is an increase in consolidated surplus of $375. On the working papers, the following adjusting entry should be made:

Capital stock (Co. A)	$10,000	
Surplus (Co. A)	3,375	
Capital stock (Co. B)	4,000	
Surplus (Co. B)	9,000	
Invest. in Co. A (Co. B)		$ 13,000
Invest. in Co. B (Co. A)		13,000
Consolidated surplus		375

CONSOLIDATED BALANCE-SHEET COMPANY A AND SUBSIDIARY COMPANY B

Assets	$137,000	Capital stock Co. A		$ 90,000
		Consolidated surplus		30,750
		Extra-group int. Co. B:		
		Capital stock at par	$ 5,000	
		Surplus	11,250	16,250
	$137,000			$137,000

In any subsequent consolidated balance-sheets, the extra-group interest will be given five-sixteenths of the change in Co. B's net worth, with Company A getting eleven-sixteenths.

The mutually held shares will remain, ordinarily, on the books of the company acquiring them. A consolidated balance-sheet may not be drawn up until some time has elapsed between the date of acquisition and the date of the consolidated balance-sheet. It may be impossible to obtain the facts with regard to book value of these shares when they are acquired, but an elimination of such shares as participants in subsequent changes in net worth must be made. This is one instance where recording investments in affiliated companies at cost or book value at date of acquisition, with no change in value recorded during subsequent periods, would help rather than hinder the compilation of a consolidated balance-sheet.