Journal of Accountancy

Volume 68 | Issue 5 Article 4

11-1939

Separate Accounting Basis v. Apportionment

M. A. Feldmann

Separate Accounting Basis *v.* Apportionment

BY M. A. FELDMANN

THE accounting principles and practices followed in determining the total net income in any fiscal period for an affiliated group of operating divisions or operating subsidiaries are reasonably well defined: there is general agreement that the operating results, as well as the financial position, of a group of related companies of common ownership are, as a rule, clearly shown only when the accounts are regarded as those of an integrated organization constituting de facto a single entity, even though each of the constituent companies is of course a separate legal entity. While this is so, the question invites consideration as to whether the accounting methods employed in determining the separate net income of each of the divisions of a related business or the net income of each of the subsidiaries of a group of related corporations are based upon principles or practices which are as well recognized or as clearly defined. Thus, while accountants might well agree as to the correctness of the consolidated or combined net income of an affiliated operating group, they might on the other hand readily find supportable grounds for disagreement as to the correctness of net income shown by each operating division or operating company within the group; and cases will almost certainly arise where taxing authorities will dissent.

As a basis for the following discussion, it is necessary to explain that references therein to separate operating divisions or operating subsidiaries of an affiliated group together constituting a business or industrial unit are limited to those types of industries which are in reality one related business, either of the horizontal or vertical type. The references are not intended to include the holding-company type of business unit, which has under its control entirely unrelated types of subsidiaries or operating divisions. Further, it may be said that the conclusions are principally applicable to manufacturing industries, rather than purely mercantile companies.

The various states having income-tax laws have generally recognized the difficulties inherent in determining the income earned within the taxing state where a taxpayer is engaged in business both within and without the state. The first attempt at determining net taxable income is usually on the basis of a separate accounting, when separate accounting records are maintained and in the judgment of the taxing authorities that method will reasonably reflect the income properly taxable by the state. Where it is believed, however, that method does not reasonably reflect the income properly taxable by the state, there is resort to an apportionment of the consolidated income of a group on the basis of prescribed statutory formulae for apportioning income between the taxing state and other states where operations are carried on. It is therefore apparent that taxing authorities have generally given recognition to both the separate accounting basis and the apportionment basis for determining the income of particular operations within an affiliated operating group.

Illustrative Situations

Analyses of existing situations raise important questions as to the substantial accuracy of the income determination on a separate accounting basis in those cases where the intergroup transactions are of material significance. It appears upon analysis and investigation that in many such cases the operating results on a separate accounting basis are modified by the application of more or less arbitrary figures, or so-called "standards," for certain items of income or expense affected by intercompany relations. A review of a few factual situations will serve best to illustrate this point.

Group A

Group A is a maltster operating four divisional malt plants, one in each of four states, with varying capacities. One principal administrative office is maintained at one of the plants, but sales orders are accepted and delivery made from the plant closest to the customer market. Similarly, barley is purchased at varying prices by each plant from its closest available growers. Thereafter numerous transfers are made of both barley and malt between plants to suit the production facilities, storage facilities, and customers' demands. Such transfers are made at the currently existing market prices for barley (plus estimated cost of conversion in the case of malt) at the date of transfer, and corresponding entries made in the accounting records on the separate accounting basis. Somewhat similarly, sales orders may be received and accepted at one plant at contract prices but, because of availability of desired standards of quality, turned over to another plant to make delivery, such sales being credited to the plant making shipment.

The separate accounting records reflect the net income of each plant on the foregoing basis of operation. It is at once apparent, however, that they do not in any real sense represent actual operating results from the standpoint of the net income contributed by each to the combined net income of the group because of the large volume of interdivisional transfers which are treated as divisional sales.

The separate accounting basis described nevertheless affords the best available means for management control of divisional operations. Indeed, almost any other method would be impracticable, due principally to the unavoidable mingling of grains in the elevators in varying quantities and at different prices.

Again, additional elements, the apportionment of which admits of no precise determination, arise in connection with certain items of administrative, advertising, and selling expenses which are paid by the principal office. What basis can be used which will properly apportion these expenses between the various plants? It is doubtful whether any formula could be devised which would allocate definitely and accurately the total net income among the plants. In the absence of such a formula, it is possible that an apportionment of the combined net income on the basis of the number of bushels of barley steeped at each plant in relation to the total steepage would provide a reasonable basis for such an apportionment, since steepage more than any other factor forms the primary basis of profitable operations. Another possible basis would be a combination of steepage and fixed assets, but whatever basis is adopted, it seems clear in this instance at least that actual dollar sales would not be a fair factor to use in arriving at an apportionment fraction.

Group B

Group B is in the apparel manufacturing business and consists of a parent and one wholly owned subsidiary. The parent operates several factories within one state, and the subsidiary is a selling organization operating in numerous states. The parent sells approximately one half of its output direct to dealers and the balance to its sales subsidiary, the product being sold to the subsidiary at regular established dealers' prices, less only a nominal quantity discount. The parent company earns a substantial income on its operations on a separate accounting basis, and the subsidiary suffers substantial losses on its operations on a separate accounting basis, the history of its operating results showing but little variation. Further, the consolidated net income represents generally a fair return on the total capital invested.

Now, while the separate accounting provides a measure of operating effectiveness and furnishes the data required for managerial control, it is obvious that the operating results shown by the separate accounting of the parent and its subsidiary are open to large reservations. There can be no question but that the substantial part of the parent's production absorbed by the subsidiary contributes substantially to the consolidated income in as much as, without the outlet for one half of its product, the manufacturing parent would undoubtedly be adversely affected to a major degree. In such a case as this it seems clear enough that the operating results of each company are not properly determinable on a separate accounting basis.

Group C

Group C, which manufactures paper, consists of a manufacturing parent and subsidiaries with timber holdings in other states. The major raw material is provided by the subsidiary companies, which bill the parent company for pulpwood at established current market prices. Again the group as a whole realizes what is regarded as a reasonable net income based on the total capital invested, but the logging subsidiaries invariably sustain operating losses, due principally to relatively high-cost timber and consequently high stumpage-depletion charges.

As independent units, the subsidiaries might very well suspend operations in periods when market prices of pulpwood are unremunerative and log only, or mainly, in periods when the market warrants the resumption. Such a decision, however, is beyond their control for the reason that the parent requires continuous production of pulpwood for its manufacturing needs, so that despite the operating loss shown by the subsidiaries, it is plain that actually they contribute to the net income of the consolidated group. The parent company might very well have difficulty in securing its pulpwood needs on the open market, and its large demands for pulpwood in the open market could conceivably raise the quoted market prices for pulpwood. In a word, the logging companies are really nothing more than incorporated branches essential to the group activities: to present the operating results of each of the companies as though it were an independent entity is clearly anomalous except for the procedures of management.

Group D

Group D represents a parent company engaged in both manufacturing and in selling at retail, operating in numerous states and also having manufacturing subsidiaries packing canned goods in several states other than those where distribution is made. The subsidiaries dispose of their entire output to the parent at the current market prices obtaining in the industry and thus determine their net operating results on the basis of separate accounting.

It is evident that under such circumstances the subsidiaries' operations are conditioned by the parent-subsidiary relation as a result of which the subsidiaries are relieved of administrative expenses, selling expenses, marketing expenses, and inventory losses—factors which must be considered in reviewing the operating results as shown in the separate accounting of each of the companies.

The question raised is of particular interest in connection with the taxable income in the state in which the several subsidiaries operate, for unless, with due sanction, cognizance is taken of each of the elements noted, the total recorded income of each subsidiary will be taxable by the state in which it operates. It is quite possible that the close operating relationship existing may justify the consolidation of the subsidiaries' operations with the parent's and thus require an apportionment of the total net income of the entire group to the various states according to the apportionment formula obtaining in each. The adoption of this method of apportionment might materially change the income taxable by the states in which the subsidiaries are located from the income disclosed by the books on the separate accounting basis.

Group E

Group E represents a metalworking company having two principal products, the one product made in one state (division 1) and the other product, unrelated to the first, made by a manufacturing division in another state (division 2). The only relationship from the viewpoint of operations is that division 2 sells approximately twenty-five per cent of its finished product to division 1, which uses it as a primary raw material, the interdivisional sales being made on the basis of open-market, competitive-bid prices. Separate divisional accounting records are maintained.

This situation probably represents the closest approach, of those herein summarized, of separate accounting which does in some measure reflect actual divisional operating results, but here too the situation poses certain questions. If the divisions were not related and they were dealing at arm's length, it is quite possible that the twenty-five per cent volumé of division 2 sold to division 1 would cease to be produced, since division 1 could very well afford to give its business to other manufacturers at the same bid prices. Further, while separate administrative and selling departments are maintained, there is nevertheless a certain amount of executive and administrative overhead which must be more or less arbitrarily allocated between the two divisions, and such an apportionment is not capable of precise determination.

Conclusions

The specific items under consideration respecting the application of arbitrary figures or "standards" for items of income or expense have been only briefly described in the foregoing cases; actually, in closely related divisional operations they are of wide range, but the few cited serve to illustrate the point. From a consideration of the foregoing, it is to be concluded then that divisional operating results as disclosed by the separate accounting records cannot be relied upon solely even as the basis for management decisions, but that numerous contributing factors and data must also be given careful consideration. A further conclusion is that the divisional net income shown by the separate accounting records may or may not have any close relationship to the net taxable income.

If it be true that only rarely is a reasonably accurate determination of net income on a separate accounting basis possible, what are the alternatives, both from the management viewpoint and from an income-tax viewpoint? There is no question that management must have some yardstick of factual information for purposes of control, and that purpose may properly be served by establishing certain standards for the operations of the various operating divisions. If those standards are regularly adhered to and consistently followed from one fiscal period to another, with such revision as experience determines, management has available the means of efficient operating control, i.e., the consideration of operating results based on definite operating "standards" and resulting bases of comparison. The separate accounting basis therefore does serve an important and required function from the standpoint of management, but its limitations as a true record of net operating results in relation to the total operating results of the group must, however, be given proper recognition and consideration.

The income-tax viewpoint is an entirely different matter. If it were possible to have a standard formula of apportionment adopted by the various income-taxing states, the application of such a formula to the consolidated net income, for the purpose of determining the net income taxable in each state, would probably be preferable to any other means. Its primary advantage is that in no event would more than 100 per cent of the consolidated net income be subjected to tax, whereas under the present varying methods of apportionment used by various taxing states, and the separate accounting basis used by others, it is possible and as a matter of fact it frequently happens that more than 100 per cent of the consolidated net income is taxed.

Applying the income-tax viewpoint to federal income taxes, it may be said that the inequities resulting from the abolition of consolidated returns for an affiliated operating group of corporations are many. There are instances where the separate accounting records reflect the fiction of a parent company with substantial income and an affiliated operating subsidiary with a loss almost equal to the parent's income. The parent is required to pay a tax on the full amount of its net income, without a corresponding offset of the loss of its subsidiary. Here again, the use of a formula to apportion the consolidated net income between the companies for income-tax purposes would more clearly reflect the operating results which are subject to income taxation.

The hope for equitable income-tax treatment in the future lies principally in a return to consolidated federal income-tax returns or a method of apportioning consolidated net income between affiliated operating corporations as herein described, while as to state income-taxation, the hope lies in the adoption by all the taxing states of uniform formulae for apportionment of income of affiliated operating groups between states. Having regard to the complex and involved interstate business transactions of most of our industrial units, surely the view may be fairly advanced that taxable income should be determined by the rules of reason and the claims of equity.