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CONSOLIDATED AND COMBINED STATEMENTS

Address

of

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Consolidation accounting is one of the areas in which recognized principles are few, divergent principles many, and undeveloped sectors large. This kind of accounting and this kind of statement are discussed in nearly all textbooks; certain elements are the subject of rules by governmental bodies and the New York Stock Exchange; a few articles have been written; and the professional societies have sponsored a few principles. But for the most part, these writings stick to a pretty well beaten path and rarely discuss more than a handful of questions. Published financial statements likewise scarcely every disclose any of the many difficult problems which frequently, if not customarily, arise in their preparation. On the surface all is serene and the tombstone of many a questionable or hotly debated treatment is labeled "consolidated goodwill" or "consolidated capital surplus."

Yet, when on occasion it is necessary to go behind the statements and consider the way in which particular transactions were handled, an almost astounding divergence of treatment is disclosed. Moreover, it is scarcely ever possible to find written treatment of one of these problems. And, as I have already pointed out, their presence and treatment in other cases are rarely revealed. Finally, the available discussions of general principles, the landmarks, are seldom sufficiently detailed to enable one to determine with reasonable assurance which of several possible solutions would be consistent with the premise.

It is the intention of this paper to present first, some general doubts and inquires as to the basis and utility of consolidated statements; second, a survey of the requirements and rules of the Securities and Exchange Commission; and third, a few beneath-the-surface problems.

The first serious problem arises as to the presently somewhat dormant issue of what a consolidated statement is and what purpose it is to serve. To what extent, for example, are we to insist on honoring the existence of separate corporate entities and to what extent are we to disregard them and seek an economic or quasi-economic concept which looks through the entity to what is sometimes called substance? Under the former view, minority stockholders are still stockholders. Under the latter, are they creditors? Actually, many practices seem to treat them neither as the one nor the other. I need but cite, for example, the treatment of preferred dividends of subsidiaries, the interests of minority common stockholders and the treatment of intercompany transactions where minority interests exist. We cannot very well label our statements "Theory A" or "Theory B." And yet, until the dispute is settled, we will have difficulty discussing many important problems for, given different assumptions, different answers are logically unassailable.

Again, we may ask, what does consolidated earned surplus represent? Is it intended to indicate the undistributed and unappropriated earnings of the consolidated group resulting from transactions with outsiders since formation as a group? Or is the caption intended to indicate the amount accumulated since acquisition and available to the parent legally for the payment of dividends after appropriate declaratory action by the subsidiaries?

It occurs to me that perhaps we have been too prone to consider the question of consolidated financial statements as a sort of stepchild, as

something which should be written into the last chapter of the text-books. 1/ We have in this particular subject legal concepts and economic concepts; is there also an accounting concept? Irrespective of the answer, there is much to be done, in my opinion, before we shall have an integrated and logical body of accounting principles applying to the consolidation of the accounts of affiliated companies. Some evidence of the lack of development in this field is found in the very frequent resort to the argument that the treatment of a particular transaction depends entirely on the circumstances and in the maze of exceptions which are found grafted onto a so-called general rule.

There is perhaps no issue more debatable than that of when a consolidated statement is more likely to be misleading than not; or, to put it differently, under what conditions is it proper to consolidate a particular subsidiary? I propose to discuss this problem in connection with our requirements but I mention it here as perhaps the best example of a field in which the only rules are negative, and any statement of a positive rule is subject to so many exceptions whose merit is hard to deny as almost to outweigh the rule itself.

The Acts administered by the Commission give to it in various ways the authority necessary to enable it to require or prohibit the use of consolidated financial statements and also to regulate the form and content of such statements, including any accounting questions that may arise. Under the first of these Acts, the Securities Act of 1933, this authority is embodied in Sec. 7, which provides for information required to be furnished in registration statements, and Sec. 19 (a), which gives to the Commission broad authority to define accounting, technical and trade terms used in the Act and methods to be followed in the preparation of accounts and consolidated statements when deemed necessary or desirable.

Applicable provisions of the Securities Exchange Act of 1934 include Sec. 12 (b) and (c), which govern the content of applications for registration of securities upon national securities exchanges, and Sec. 13 as to periodic and other reports, of which subsection (b) is very similar to Sec. 19 (a) of the 1933 Act. Sec. 15 (d) requires comparable reports by certain issuers which have registered securities under the 1933 Act.

The Public Utility Holding Company Act of 1935 provides in Sec. 5 (b) for the content of registration statements. Sections 14 and 20 (a) deal with periodic and other reports and with rules, regulations, and orders. These two sections, taken together, cover much the same ground as Sec. 13 of the 1934 Act. Sec. 15 is of particular interest since it empowers the Commission to prescribe uniform classifications of accounts for companies subject to the Act. While no effort has been made to prescribe

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1/ There are three books devoted exclusively to the subject of consolidated statements and parent and subsidiary accounting. They are: *Consolidated Statements for Holding Company and Subsidiaries*, by Finney, published in 1922; *Consolidated Balance Sheets*, by Newlove, published in 1926; and *Holding Companies and Their Published Accounts*, by Garnsey, published in England in 1923. In general, these books are an exposition of the technique of preparation of consolidated statements.

classifications for operating utilities required to use the F.P.C. or a stated classification, a recent rule, U-27, requires companies not otherwise required to use a classification, to follow the F.P.C. system, or in the case of gas companies that prescribed by the N.A.R.U.C.

The Investment Company Act of 1940 follows a somewhat similar pattern. Thus, Sec. 8 regulates registration statements and contents thereof, and Sec. 30 provides for the filing of periodic and other reports. Sec. 24 relates registration under this Act to registrations under the 1933 Act. Both in this section and Sec. 30 the provisions are coordinated with the 1933 and 1934 Acts and permit the Commission to eliminate the filing of duplicate material where appropriate.

The principle embodied in the sections to which I have referred is that the Commission is empowered to require the filing of consolidated statements in those circumstances and conditions where, in its opinion, such statements are necessary or desirable. If there is anything in the provisions which might be emphasized I think it is that it was intended to leave to the Commission the decision as to what financial statements are to be submitted. In no case do the Acts either require or prohibit consolidated statements.

Financial statements required to be filed with the Commission are designated in the various forms or instructions thereto which have been adopted in order to provide for the registrations, applications, and reports contemplated by the Acts. There are some differences among the forms as to requirements in connection with consolidated statements for the obvious reason that the forms serve different purposes and in many cases apply to companies having special characteristics. It is not necessary to review many of the Commission's forms but it may be helpful to consider representative instructions dealing with consolidated financial statements.

Before doing do, however, I wish to point out once more the relation of Regulation S-X to the forms. This regulation prescribes the form and content of financial statements required to be filed as a part of the major forms, particularly 10, 10-K, A-2 and N-8I-1. Forms adopted prior to the promulgation of the regulation contain instructions as to financial statements including rules as to the form and content of the particular financial statements therein specified. As to the forms enumerated in Rule 1-01, such rules as to form and content are now superseded by those of Regulation S-X. However, this regulation does not designate the persons, or the dates or periods for which financial statements are to be submitted.

Form A-2, used for most of the registration statements filed under the Securities Act of 1933, is illustrative of the requirements in the principal forms under both the 1933 and the 1934 Acts. As may be expected, in the case of registrants having subsidiaries, there are required to be filed the balance sheets and profit and loss statements of the registrant and of the registrant and its subsidiaries. This is subject to the exception that a profit and loss statement of the parent need not be filed where the parent is primarily an operating company, and where consolidated statements are submitted in which the included subsidiaries are wholly-owned, are in practical effect operating divisions of the parent and owe no long-term debt to outsiders. The reason for the exception lies in the fact that in the circumstances the parent would be in such a position as to control at will the

distribution of profits or the determination of other policies of the subsidiaries. However, a separate balance sheet and surplus statement are required for the parent.

The significant aspect of the instruction is the fact that it requires statements of both the parent and the parent and its subsidiaries consolidated. Despite the urging of many accounting writers for a number of years, this principle has rarely been followed by companies in their published reports. Our view is that the legal existence of the central and controlling company in a system is a fact of major importance. Add to this the fact that consolidated statements lend themselves readily to concealment (intentionally or otherwise) of vital relationships, and the conclusion is clear that parent statements cannot often be omitted with safety.

Perhaps the major change effected by Regulation S-X is found in Rule 4-02. In the forms the principle of consolidation was to be such as, in the opinion of the registrant and its officers, would most clearly exhibit the financial condition and the results of the operation of the registrant and its subsidiaries. The new rule, however, omits the language "in the opinion of the registrant and its officers" and thus makes the basis of consolidation subject to objective standards and for that reason to review.

As to majority-owned subsidiaries not consolidated, the form requires that there be submitted either (i) separate sets of statements in which all such subsidiaries are consolidated or combined in one or several groups, or (ii) individual statements for each such subsidiary not therein included. These statements need not be furnished when the subsidiaries not consolidated are not significant in certain stated respects. This requirement of the form as to majority-owned subsidiaries not consolidated is implemented by Rule 4-03 of Regulation S-X which specifically requires that combinations of unconsolidated subsidiaries shall be in accordance with principles of inclusion and exclusion which will clearly exhibit the financial condition and results of operations of the group or groups. Also, the regulation states that if essential to a properly summarized presentation of the facts, such combined statement shall (not may) be filed.

The requirements as to the financial statements included in the basic filings under the Public Utility Holding Company Act of 1935 are substantially different from those which I have mentioned under the other Acts. Forms U5B and U5S, registration statement and annual supplement respectively, contain nearly identical instructions as to financial statements. Owing to the extent of regulation imposed by the Act it is essential that there be available financial information as to every company in a holding-company system. The simplest medium for presentation is a consolidating statement supported by detailed analyses of eliminations and adjustments, and that is what these forms require. Where statements of certain companies are not customarily included in consolidated statements it is required that they be separately submitted.

There is one other form which I should like to mention, namely, Form N-8B-1 which is used for the registration statement to be filed by most management investment companies pursuant to the Investment Company Act of 1940. I think this is of special interest because the form was only recently adopted, and in view of the prior existence of Regulation S-X

(which was not true in the case of most forms), it was not necessary to provide in the form all appropriate instructions as to financial statements. Instead, the instructions indicate what statements are to be submitted, with the added instruction that Regulation S-X shall, except in certain stated matters, govern the form and content of all such financial statements. Consolidated or group statements of investment trusts are permitted only if accompanied by a consolidating or combining statement showing separate statements for each significant subsidiary. In any event, of course, the group or consolidated statement is subject to the general provision of Rule 4-02 that the principle of inclusion and exclusion be such as will clearly reflect the financial condition and results of operations of the combined companies. It should also be noted that a special rule as to significance applies under the Investment Company Act. This rule replaces the general definition included in Regulation S-X.

Before taking up portions of Regulation S-X which relate specifically to problems of consolidation, I would like to point briefly to one general rule which has special application because of the unsettled state of the art with respect to consolidated statements -- that is Rule 3-06, which provides that "the information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." A liberal application of that rule should do much to avoid some of the common pitfalls of consolidated financial statements.

Article 4 of Regulation S-X deals exclusively with consolidated and combined statements. Rule 4-02 touches the broad subject, to which I referred earlier, of whether it is possible to outline any general standards for determining the basis of consolidation. The rule states only that the registrant shall follow in the consolidated financial statements principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations, and prohibits from consolidation only less-than-majority-owned subsidiaries subject to certain further exceptions in the case of insurance, investment and bank holding companies. The first authoritative pronouncement which, to my knowledge, used language similar to that adopted by the Commission was the bulletin *Examination of Financial Statements*, in which the American Institute took the position that control was the first test to be applied, but that in some situations it might be advisable to consolidate companies not majority-owned, although emphasizing that this should not ordinarily be true.

In the booklet written by Messrs. Sanders, Hatfield and Moore entitled *A Statement of Accounting Principles*, the authors take the position that companies not majority-owned may be included in consolidation in some cases provided control is present, such control not necessarily depending upon voting power. This view seems to look to the consolidation of companies that constitute one economic enterprise. On the other hand, Trouant in his book *Financial Audits*, states that "Companies which are not controlled through ownership by members of the group of more than 50% of the voting stock should not be included in the consolidated group." However, he clearly regards a consolidated group as an economic enterprise.

In their *Tentative Propositions Underlying Consolidated Reports*, the executive committee of the American Accounting Association takes a view similar to that contained in the *Statement of Accounting Principles* to the extent that control is considered more important than the degree of stock ownership. In the *Tentative Propositions*, however, subsidiaries to be excluded are explicitly listed among which are (1) a subsidiary whose operations are unrelated to those of the parent and any other subsidiary, (2) a subsidiary about to be disposed of, (3) a foreign subsidiary, especially under certain stated conditions, and (4) a subsidiary the control of which has been acquired at a figure substantially and unaccountably in excess of or less than the corresponding fraction of the recorded or appraised amount of its net assets at the date of consolidation. Subject to the specifically excepted subsidiaries, the *Tentative Propositions* would insist upon the inclusion of all subsidiaries in the consolidated statements.

The New York Stock Exchange listing agreement, prior to the Securities Exchange Act of 1934, provided merely that if consolidated statements excluded any companies a majority of whose equity stock was owned the caption of the statement should indicate the degree of consolidation.

Rule 4-02, in contrast to those of the Institute and the Association, is directed to the consolidation of companies which represent a central financial interest rather than an economic entity. To my mind, an approach to the question solely on the basis of economic entities is apt to be fruitless, first, because the idea of what constitutes an economic entity is ill-defined and highly debatable, and, second, because the results are not likely to be useful except perhaps to an economic statistician.

Our rule, moreover, is, beyond the general principle to be followed, negative only. It excludes companies which are not majority-owned. Ordinarily it appears customary practice to put the minimum required voting power much higher. It would, however, be very difficult to require a greater ownership and at the same time foresee and provide for the necessary exceptions. For example, one registrant had a number of totally-held subsidiaries and one subsidiary about two-thirds owned. Of the sales of the parent a third were to the latter subsidiary and about half of the sales of the parent and its wholly-owned subsidiaries were to this company. Moreover, this subsidiary owed substantial sums to the parent on installment accounts. The registrant wished to exclude this subsidiary from the consolidated statements and upon being notified that the subsidiary must be included in the consolidated statements withdrew its registration statement.

Another sector of the problem involves the extent and relative position of outside interests in the form of preferred stocks, bonds, and other debt. Illustrations abound of cases in which consolidation serves to conceal rather than reveal. The question is, should this be prevented by prohibiting the inclusion of subsidiaries where the outside interests are very large or even predominant? Or is the answer to be found in supplementary schedules or statements? In extreme cases it is possible that only consolidating statements could completely disclose the true situation. Or perhaps in lieu of complete consolidating statements, which in a normal case might consist of unnecessary detail because of the number of subsidiaries involved, consideration might be given to condensed, consolidating statements or schedules in which all subsidiaries are combined in one or more

groups except those as to which the special features attach. A schedule along these lines was proposed for inclusion in Regulation S-X but was not adopted. The proposed schedule was designed to show details of the more important consolidated totals broken down as to important subsidiaries and groups of subsidiaries. Eventually it seems likely that some solution along the lines of one of these possibilities will be demanded. It has already appeared in a number of instances.

It may be worthwhile to catalog the various criteria which some observers have considered to be wholly or partially determinative of the question whether to include or exclude a particular subsidiary in consolidation with its parent. I have grouped these into the following six divisions: Degree of control, degree of ownership, type of business, operating relations, peculiar characteristics of the subsidiary, and the purpose for which the consolidated statements will be used. These divisions are not mutually exclusive but instead overlap to a considerable degree. Perhaps the most frequent test is the degree of control in terms of percentage of voting stock. The critical points are of course working control, majority control, and substantially complete control. But even these may be modified by the contingent voting rights of a prior class of securities. In some cases control may not depend upon ownership as in the case of a voting trust or a long-term lease or, indeed, of a management contract.

No matter what the degree of legal or business control may be, there is always the question of the degree of ownership. If the investment and equity of a legal parent is extremely small in comparison to the total resources of the subsidiary, it may be questioned whether consolidation is a proper means of expressing the relations of the two companies. This question is sharpened if there exist defaults on prior securities or arrearages in dividends and, in general, by the charactheristics of the prior claims, including restrictive indenture provisions and the like.

Some base their conclusion as to the desirability of consolidation on the comparability of the business of the two units. In addition to recognizing differences in the business done, these lay special stress, for example, on differences in the character of the assets, in the relation of costs to income or of earnings to capital, and would question the desirability of consolidation where to do so would produce relationships between the balance sheet and income figures that lacked meaning. On the other hand, few if any would insist on separate statements where the two businesses were operated as branches of the same corporation without the intervention of separate legal entities. It may well be, however, that the fault lies in the difficulty of segregation in the latter case, rather than in the rule in the former, and accordingly it would be the latter case and not the former that is to be criticized.

A closely related test is that of operating relationships. Where a company operates all of the assets of another company, some would require consolidation as in the case of system statements for railroads. In the industrial field the critical facts seem to be the proportion of intercompany sales and purchases of goods or intercompany utilization of services, or intercompany financing arrangements. To generalize, it is a question of the functional relationship of the subsidiary's business to the business of the parent and its other subsidiaries. The provisions of Rule 4-09 of

Regulation S-X incorporate something of this test. That rule first prohibits the consolidation of insurance companies with the statements of any other person but provides an exception where the insurance business done arises solely out of the business activity of a parent which owns the insurance company outright. The type of business is quite different but the relationship between the business of the insurance subsidiary and that of its parent is so close as to warrant consolidation.

Superimposed on the above tests are a group of conditions which ordinarily relate to the particular condition or character of a given subsidiary. These would include such questions as insolvency, organization and operation in a foreign country, restrictions imposed by the foreign country, and regulation by a Federal or State agency.

Finally, some direct attention to the purpose which the statements are to serve. Statements prepared as a basis of obtaining bank credit may be treated differently, for example, from those prepared for the purpose of an administrative body vested with numerous regulatory powers. 2/

Under present conditions if each of the above were made into a positive or negative rule, it would be subject to so many exceptions that the conclusion would be clear that the rule itself had not reached the heart of the matter. Even less is available as to the basis for grouping or consolidating subsidiaries of a common parent without including statements of the parent itself. Both of these topics warrant a good deal more effort than has been directed toward them in recent years.

Rule 4-04 requires a statement of the principle of consolidation followed and an indication of any companies included or excluded which are not similarly treated in the preceding period. The objective of the rule is apparent: to inform the investor of the basis of consolidation and the results of its application as between years. Nor will the rule be satisfied by a statement that "the registrant follows a principle of inclusion or exclusion which will clearly reflect the financial condition of the group and results of its operations." Such a rule, of course, has no objective test and little informative value. Instead, it is necessary that the registrant adopt some rule, such as that it will consolidate all majority-owned subsidiaries or all majority-owned domestic subsidiaries or all subsidiaries of which it owns 90% voting control. A statement is required in the accountant's certificate if the principle is changed, as from majority-owned subsidiaries to majority-owned domestic subsidiaries, but not if the same principle is followed even though certain subsidiaries are excluded or included because of factual changes during the period. Thus, if a company followed the rule of consolidating all majority-owned subsidiaries and during the year brought its ownership of a particular company to less than a majority, a note of this change would be required by Rule 4-04 (b) but no comment would seem to be necessary in the accountant's certificate.

2/ Two frequently mentioned reasons for a particular principle of consolidation that rather defy classification are these: First, that the number of subsidiaries is so great that no other device is feasible and, second, that when a subsidiary is inactive, even though it may hold large assets, it ought not to be included in consolidation.

Rule 4-05 asks in effect for a reconciliation of the amount of the investment of the parent in its consolidated subsidiaries and the amount of the equity of the parent in the net assets of such subsidiaries. Proper disclosure under this rule requires, of course, that a distinction be made between earnings since acquisition and excesses or deficiencies at the date of acquisition, and that the treatment accorded the several elements in the statements be clearly set forth. In the case of unconsolidated subsidiaries, merely the amount of difference is required to be given, together with a reconciliation of dividends received from and earnings of such subsidiaries.

Rule 4-07 requires disclosure of the minority interest in capital and in surplus, separately shown. It also asks for the interest of the minority in the profits or losses for the period. The rule is only one of disclosure and does not seek to decide the question of whether for the purpose of consolidated statements the interest of the minority should be treated as debt or stock. Strangely enough, these two rules which I had thought were pretty well accepted on all sides have given rise to a number of deficiencies. Indeed, we have two or three cases in which statements were prepared on the basis of excluding from the income statement and from the balance sheet a sufficient amount of assets and income to account for the minority interests. In such statements of course all reference to the minority interests is excluded except by way of footnote.

Rule 4-08 includes one point of particular interest. The first sentence which states that intercompany items and transactions shall be eliminated is a positive statement of an accounting principle. The rules in Article 4 which we have so far considered (and in general the Regulation) are largely requirements as to disclosure, that is, principles of display. Except where the Commission has expressed itself publicly as to an accounting principle, its policy (as stated in Accounting Release No. 4) has been not to overthrow the accounting principles followed by registrants provided there is substantial authoritative support therefor and appropriate disclosure is made. While the rule covers a principle which is elementary and about which there seems to be universal agreement, yet we have had cases where intercompany items were not eliminated and not satisfactorily explained. There is, of course, no unanimity of opinion as to the amounts to be eliminated. The *Tentative Propositions* mentioned earlier insist that intercompany accounts, gains, losses and transactions should be completely eliminated, irrespective of any minority interests. Without this procedure it is said confusion of "costs" remains which does not reflect the unitary position of the combined enterprise. Other authoritative sources do not subscribe to this view.

Rule 4-09, 4-10, 4-11 and 4-12 provide requirements as to companies having special characteristics. Except in very limited circumstances the statements of an insurance company may not be consolidated or combined with the statements of any person. This rule is consistent with the fact that in general such practice is prohibited by the regulations of state governmental agencies. Subject to the one indicated exception which, I believe, speaks for itself, consolidation of insurance companies would only confuse the analysis of the companies involved.

The rules as to investment companies and bank holding companies provide almost identical requirements in that such registrants may be consolidated only with subsidiaries of like character and then only if consolidating statements are also submitted. Consolidation without disclosure of the individual

statements is not permitted because of the dangers inherent in commingling of investment portfolios. In the case of investment companies the rule as originally expressed in the several forms began a departure from previous general practice in that the requirements for listing such companies on the New York Stock Exchange permitted the filing of consolidated statements only, provided the securities owned by each subsidiary were shown separately. The principle of disclosure required in our rule as to unconsolidated subsidiaries is similar to the provision as to subsidiaries included with the parent.

Among other rules in the Regulation which might be of interest in connection with consolidated statements is Rule 1-02 containing definitions of majority-owned subsidiaries, significant subsidiaries, and totally-held subsidiaries. Not long ago we received an inquiry as to the first of these which raised an interesting question. It was asked whether or not the definition of a majority-owned subsidiary had been changed because in the S-X rule the words "other than as affected by events of default" were not included after the words "voting power". The answer rests in the meaning of the term "voting power" which is defined in various forms to be the right, *other than as affected by events of default*, to vote or direct votes for the election of directors. Clearly, it is unnecessary to give this qualifying phrase in both definitions.

There have been many interesting problems revealed in connection with consolidated financial statements filed with the Commission. Consideration of those of more than average complexity is profitable not only because it is a step toward solution but also because the discussion of them stimulates original thinking. I should like to present a few of these problems with both of those purposes in mind.

In September 1939 the Committee on Accounting Procedure of the American Institute of Accountants began the issuance of a series of Accounting Research Bulletins. One of the rules listed in the first bulletin as having already been adopted by the membership of the Institute relates to earned surplus of a subsidiary company. It is stated that such surplus from earnings prior to acquisition does not form a part of the consolidated earned surplus of the parent and subsidiaries; and that any dividend declared out of such surplus may not properly be credited to the income account of the parent company. In my opinion, there is no question as to the soundness of this well-known doctrine. 3/ However, question has been raised as to the full implications of the term "date of acquisition". A familiar illustration given by textbook writers assumes a situation wherein majority ownership of a subsidiary is obtained by one single purchase of stock, and proceeds then to show how subsequent purchases of stock result in a composite figure for surplus at date of acquisition the treatment of which must be in accordance with the rule cited. The situation I have in mind may be introduced by the following assumed facts: Corporation A in 1930 acquires a 40% interest in Corporation B and in 1940 increases its ownership to 51%, the latter representing control. Does the composite idea as to surplus at acquisition apply in this case or does all of the parent's share of the

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3/ There have been a few instances before the Commission where registrants departed from the rule and in each case amendment of the statements was required.

surplus at the 1940 purchase date become frozen, that is, subject to elimination in consolidation? Theoretically, it may be argued that the surplus of the subsidiary earned during the ten-year period applicable to the 40% interest therein owned during that time should be earned surplus in consolidation or earned surplus on Corporation A's books if paid out in dividends by Corporation B. This would be consistent with prevailing principles applied to situations involving separate purchases subsequent to acquisition of control.

Theoretically, acquisitions before and after the date of acquiring control are no different, if the treatment rests on the premise that the price paid for stock represents a purchase of an equity in the net assets of the corporation and that dividends received are income only if earned after the purchase date - distributions not earned after that date being regarded as simply a return of part of the purchase price.

The difficulty in applying the theory may rest upon the practice of Corporation A prior to the acquisition which gave it control. Corporation A may have viewed as earned all dividends received during the period of 40% ownership. In order to apply the theory completely it would be necessary, upon acquiring control, to go back and seek to make a determination as to whether the dividends in fact were declared out of earnings subsequent to the date of the minority acquisition. In the particular illustration such a determination might be desirable and not difficult to make. At least it seems to me it might be questionable to deny Corporation A the right to do so. On the other hand there is the question not of 40% ownership and majority ownership but of, say, 5% and 51% or a series of stages of minority ownership, especially over a substantial period of years. In other words, when is the theory to be applied?

The *Tentative Propositions* of the American Accounting Association states: "The date on which control was acquired may conveniently be referred to as the 'date of acquisition.'" This does not, of course, answer the questions asked. Montgomery in his *Auditing Theory and Practice* is one of the few writers who define and attempt an answer to the problem. In his opinion, "all acquisitions of the subsidiary stock through the date when a controlling interest has been accumulated should be considered together and their aggregate cost compared with the relative net assets of the subsidiary at that date." 4/ This is unquestionably a practical solution and one which apparently recognizes that, with corporations as with individual investors, the price paid for stock, particularly of small amounts, often involves a great many factors other than book values.

A number of interesting questions have arisen from time to time in connection with stock dividends. The Institute's Accounting Research Bulletin No. 11 made a notable contribution to the subject in taking the stand, among other things, that "an ordinary stock dividend is not income from the corporation to the recipient in any amount." Although parent-subsidiary dividends are excluded, we may accept the view for the moment. If we do, how shall stock dividends declared by a subsidiary be treated in consolidation?

Various practices seem to have been followed. Some have in effect reversed in consolidation the parent's interest in this capitalization, that is, have transferred the parent's equity therein back to consolidated earned surplus. The procedure might be defended on the grounds that consolidated earned

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4/ 6th Ed., p. 517.

surplus is not in any event surplus available for dividends, that the only absolute certainty of realization by a parent of subsidiary surplus rests in dissolution of or merger with the subsidiary (or possibly reorganization) under which circumstances capitalized and uncapitalized surplus would meet the same end.

Another view recently taken by some is that in consolidation the parent's portion of the capitalized surplus should be credited to consolidated capital surplus. This recognizes as do other views that although on the subsidiary's books the credit rests in capital stock it cannot be thus shown in consolidation because it is not stock in the hands of the public. It is then argued that this uneliminated credit could not be passed back to earned surplus in consolidation because we must proceed with a going-concern, not a liquidating, point of view, and on that basis realization of the capitalized surplus by the parent is precluded. Also, this would be consistent with the purpose for which the stock dividend was declared. Both capital stock and capital surplus, in an accounting sense, are generally considered to be capital, and since the credit may not be shown as capital stock in consolidation and since the earnings are clearly frozen as capital by managerial action the credit is thus to be treated as capital surplus.

There appears to be at least one objection to this procedure. Without entering into a discussion of the implications of the term capital surplus I think that under present views there is attached to it the thought of capital transactions with the stockholders. In a consolidated balance sheet this may mean parent stockholders, and capital surplus would seem therefore to relate to transactions involving them. It follows that the wrong interpretation might and probably would be given to the account if the parent's equity in capitalized earned surplus of a subsidiary were included therein. In view of this, I am inclined to give some thought to the use of a separate, distinctive caption which would avoid these objections. Why not call it simply: "Parent's equity in earned surplus of subsidiary capitalized"? The caption could be shown in the capital and surplus section immediately following capital stock or after capital surplus, if any, since the item clearly involves "capital" of the system.

Nor do the interesting aspects of this problem end with a decision on this point. Suppose at some later date the capital of the subsidiary is reduced in an amount equal to the capitalized earnings, to what account should the reduction be credited? On the books of the subsidiary it is clear, I think, that the credit must be made to capital surplus and not to earned surplus. Is it possible to make a transfer of this amount in consolidation from capital surplus to earned surplus? The answer of course depends on the definition to be assigned to consolidated earned surplus. A somewhat related problem is the disposition to be made in consolidation of capital surplus arising subsequent to acquisition by virtue of dealings in stock of the subsidiary held by the public, particularly when the class of stock to which it relates has been completely retired.

Another question that will bear discussion involves the sale of a subsidiary's bonds by the parent. Suppose, for example, that in a simultaneous transaction a parent acquires bonds issued by its subsidiary and immediately sells such bonds to the public or to underwriters at less than the subsidiary's issue price. How should this be treated on the books of the parent and in consolidation? The consolidation problem does not perhaps present

as difficult a question as the accounting treatment on the parent's books does, and as parent and subsidiary problems are closely related to those of consolidation, it is, I think, appropriate to consider them. As to the parent the principal question would be, it seems to me, whether discount may or should be treated as a deferred charge and amortized over the life of the issue or whether such discount should be written off immediately. In the latter event question would arise as to what to charge. Possibilities might include earnings or earned surplus, or perhaps even the investment account, on the basis that the discount represents a capital donation. In seeking an answer one thing which must be met will be the extent to which the parent should, may or must disregard its subsidiary's accounting; other matters involved are the creation of fictitious profits and the so-called "milking" of subsidiaries and, in the case of a profit by the parent, the effect in consolidation where such profit has been taken up by the parent and paid out in dividends.

Accountants are, of course, familiar with the many problems associated with undeclared cumulative dividends on subsidiaries' preferred stock. One in particular comes to mind, in part because of related questions suggested. At the date a parent acquired a majority of the voting stock of a subsidiary there may have existed undeclared cumulative dividends on the subsidiary's preferred stock. In the preparation of consolidated statements the parent may have followed various methods in computing the important figure of surplus at acquisition. For example, the unpaid dividends may have been ignored or they may have been accrued in part or in total with a corresponding reduction in the amount designated as surplus at acquisition. The method followed will affect the uneliminated excess which in turn may involve, depending on the procedure used, such consolidated accounts as fixed assets, goodwill, capital surplus or merely the excess itself as a separate caption. In any event, it becomes necessary to decide the extent to which these dividends should be provided for in computing acquisition surplus, first, in case the subsidiary has earned surplus in excess of the dividends and, second, in case the subsidiary has only a portion of the necessary surplus. The illustration may be extended to assume that at some later date the parent purchases a substantial portion, say half, of the subsidiary's preferred stock and that up to that time no preferred dividends had been declared or paid. Under such conditions, how are dividends accrued at the acquisition date, as well as subsequently accrued dividends, to be treated in consolidation as respects the portion acquired by the parent?

I should like to emphasize finally the need for an integrated solution of these questions. Individual problems ought not to be solved in a vacuum; there should instead be kept in mind the conclusions reached as to other questions. Moreover, development of an integrated body of principles underlying consolidated statements is still in its initial stage. To this extent solutions frequently must be deemed tentative and subject to revision in the light of changes in basic and fundamental premises. I do not mean to imply that such tentative solutions are not useful and necessary. But it would be unfortunate, in my opinion, if the mere precedent established by the repeated use of a given practice should have the effect of precluding a reconsideration of the principles involved.