

ABSTRACT

SUGGESTED CRITERIA FOR THE INCLUSION OF THE ACCOUNTS OF FOREIGN SUBSIDIARIES IN CONSOLIDATED STATEMENTS

by Irving M. Bonawitz

The objective of this thesis is the development of criteria for the consolidation of foreign subsidiary companies. A condition precedent to this objective is the development of criteria applicable to the consolidation of domestic subsidiaries.

Existing criteria are reviewed. Examination of the pronouncements of three major professional organizations reveal general agreement on consolidation criteria with a tendency to permit individual judgment to prevail in most situations. Analysis of current practice indicates that little uniformity exists. Majority ownership of voting shares and homogeneity of operations are revealed as the primary factors in decisions regarding consolidation.

Possible restrictions on fund movements has had considerable influence upon attitudes expressed in official statements about the consolidation of foreign subsidiaries. The consequence of this factor has been the creation of an exception to the rules of thumb of majority ownership and homogeneous operations. There is less uniformity in this area than in the area of consolidation of domestic subsidiaries.

To arrive at conclusions regarding the adequacy of existing criteria an investigation of theory is undertaken. To insure consistency, the concept of the economic entity is investigated in steps originating

with one of the least complicated forms of enterprise; the single corporation. Groups of corporations in the forms of consolidations and mergers are considered in a progression to the usually more complicated parent-subsidary relationship.

Four basic concepts of the corporation are examined. The so-called legal concept is discarded immediately because of lack of acceptance by the accounting profession. The entity and proprietary theories are seriously considered. The entity theory applies only to the corporate form of organization. Its strict interpretation leaves no room for the concept of an economic entity consisting of several corporations. Its acceptance results in conflicting accounting practices. Its roots are found in legal technicalities which were never meant to be the source of a theory of accounting and among which there is no basic agreement.

The proprietary theory does not entirely fill the void left by the rejection of the entity theory but it is accepted as superior to the entity theory and as a base for the social institution concept of the corporation. The conclusion is that the concept of stockholder ownership and direction of corporate affairs is accepted by both the courts and the public. It is also concluded that the rights and powers of the stockholders are curtailed or eliminated if they conflict with accepted social norms. The social institution concept of the corporation is the only concept consistent with these restrictions.

Minority control of the individual corporation is a widely recognized possibility. It is also prevalent in the cases of the consolidation or merger. It merits recognition in the parent-subsidary relationship. Hence,

administrative control is advanced as a criterion for consolidation, with no reference to majority ownership.

Lack of homogeneity is characteristic of the operations of many mergers and consolidations. It is also true of the individual corporation. It is suggested that this factor be eliminated as a criterion for consolidation.

It is believed that de-emphasis of majority ownership of voting shares and homogeneity will result in more accurate reporting of the affairs of economic entities.

Restrictions on the transmission of funds between nations have been greatly eased. Other restrictions have been lessened. Even in situations where these observations are not true, administrative control may exist. The burden of proof for the elimination of a foreign subsidiary from the consolidated statements falls on the exhibitor.

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CONSOLIDATED STATEMENTS**

By

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CHAPTER I

INTRODUCTION

Background

Two recent publications are the result of the continuing search for a more precise formulation of the basic concepts of accounting.¹ The continuing discussion about the methods of presentation of financial data is indicative of concern over a subject which is an extension of the postulates and principles. It is necessary that business information be presented in a form that is meaningful. The reader determines what is meaningful, based upon his objectives. Ideally, the form and content of financial statements should vary according to his preferences. The definition of the business unit should also vary according to the objectives of the reader. The decision as to what constitutes a business unit becomes more difficult when intercorporate investments exist, particularly if the investments result in a situation in which control is established by one corporation over another. The criteria which should be used to determine the boundaries of a business entity are difficult to establish. Nevertheless, it is necessary that an attempt be made to establish criteria

¹Maurice Moonitz, The Basic Postulates of Accounting (New York: American Institute of Certified Public Accountants, 1961). Robert T. Sprouse and Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises (New York: American Institute of Certified Public Accountants, 1962).

if the needs of particular groups of readers are to be met. The representatives of governmental and social units are examples of categories of readers with specialized tastes.

The recent movement towards business combinations increases the urgency for reconsideration of the reasons for and methods of presentation of consolidated statements. Concern has been expressed over the lack of uniformity regarding inclusion of specific affiliates or groups of affiliates in consolidation.¹

A significant trend has been the great increase in foreign investment which has occurred during the past three decades.

TABLE 1.--Foreign Investment

<u>Year</u>	<u>Amount</u> (Billions of dollars; book value)
1929	7.5
1946	7.2
1950	11.8
1957	25.2
1959	29.7 ²

Total assets invested abroad amounted to \$42 billion³ at the end of 1957.

Capital invested in these nonfinancial enterprises consisted of the U.S. ownership of equity capital, long-term debt, branch accounts and intercompany accounts with an aggregate book value of \$24 billion. . .⁴

¹"Comments, Suggestions Invited from Members on Intercompany Investment Research Study," CPA (May, 1962), p. 3.

²United States Department of Commerce--Office of Business Economics, U.S. Business Investments in Foreign Countries (Washington, D.C., 1960), p. 1.

³Ibid., p. 3.

⁴Ibid., p. 3.

Of the total direct investment of \$25 billion during 1957, nearly three-quarters was in enterprises in which the U.S. equity ownership was 95 percent or more (including foreign branches),¹ and 20 percent was in the ownership range of 50 to 95 percent.¹

It is increasingly recognized that the old barriers of time and distance are no longer as formidable as they were in the past. Other more artificial restraints are being removed by various international trade agreements, among them the recent changes in tariff structures. It would, therefore, seem appropriate to reconsider established attitudes about the circumstances under which foreign affiliates are considered an integral part of the business enterprise.

Purposes of the Study

If consolidated statements are useful, the question of whether criteria can be established for the purpose of determining which affiliates are to be included in the consolidated presentations deserves consideration. Assuming that it is possible to determine criteria, the criteria must be made explicit. It will be necessary to consider whether the criteria thus established must be altered to accommodate the inclusion of foreign affiliates. If alterations are necessary, the reasons should be clearly stated.

Methodology and Order of Presentation

The study is divided into two major areas. The first section is devoted to an examination of current accounting practice. A study of consolidation theory comprises the second section of the thesis. Each major

¹Ibid., p. 6.

division is subdivided into two minor divisions. The minor divisions consist of an inquiry into the general topic of consolidation, with emphasis on the consolidation of domestic subsidiaries, followed by a consideration of the problems associated with the consolidation of foreign subsidiaries.

Chapter two is a discussion of recent consolidation practices. It is not a discussion of the techniques of consolidation except for those occasions when support of a contention requires references to technique.

Chapter two is segregated into three significant parts. In part one an attempt is made to present the major topics which deserve consideration in any attempt to formulate consolidation policy. The supposition is that avoidance of the issues presented or lack of skill in dealing with them will result in a weak statement of policy.

Part two consists of a critical examination of segments of the pronouncements of the American Institute of Certified Public Accountants, the American Accounting Association and the Securities and Exchange Commission, stating the positions of the organizations on the issues previously selected. It is anticipated that this will result in an understanding of existing criteria for consolidation and an appreciation of the differences of opinion among the various bodies. This part of the chapter concludes with an estimate of the influence of the organizations on practice.

An examination of recent accounting practice in the area of consolidations is the objective of part three. Summaries of published reports and excerpts from selected reports are studied to determine the extent to

which the criteria suggested by the responsible organizations are observed in practice. Discrepancies will be noted and, if possible, reasons presented. This part of the chapter concludes with an enumeration of the most important reasons advanced for not consolidating in situations where all the other criteria for consolidation have been satisfied.

It is anticipated that the limitation of the scope of chapter two to a discussion of consolidations in general and the consolidation of domestic subsidiaries in particular will provide a satisfactory base for the discussion of the consolidation of foreign subsidiaries.

The organization of chapter three is somewhat similar to that of chapter two, and its expository technique closely parallels that of the prior chapter. The same reservations apply in regard to theory and technique. However, the chapter emphasizes the problems associated with the consolidation of foreign subsidiaries. As before, a primary objective of the chapter is an enumeration of the reasons given for the non-consolidation of subsidiaries which seem to fulfill the requirements for consolidation. The two sets of reasons are compared, differences between them noted, and the validity of the second set considered briefly.

The remaining chapters are devoted to an inquiry into the theory of the business entity. The general intention is to construct a theoretical framework that will apply to all forms of business organization. However, the corporate form of organization is of primary concern. In chapter four the theory of the economic entity is developed. Chapter five consists of

a discourse on the topic of business combinations. The subject of the next three chapters is the theory of consolidations. Chapter nine deals with the problems associated with the consolidation of foreign subsidiaries. The final chapter is a presentation of the summary and conclusions derived from the study.

A fundamental objective of the chapters included in the second major section of the thesis is the derivation of principles from the theory promulgated. Consistency of theory and principles permits the establishment of criteria for consolidation which are generally applicable to all situations. Special reference is made to conditions surrounding overseas operations which may affect the established criteria, particularly restrictions on the transmission of assets.

CHAPTER II

CONSOLIDATION OF SUBSIDIARIES

Introduction

This chapter consists of five parts, including the introduction and conclusion. In the second part certain basic questions are considered. One of the better sources of questions and their answers are the individuals engaged in professional practice. However, because practitioners are intimately concerned with the subject matter their opinions may be biased.

The pronouncements of two leading professional organizations and one regulatory body are considered in the third section. While it may be alleged that other forces exert great influence on consolidation practice, it may also be contended that their influence is to a considerable extent felt in the pronouncements of the three groups chosen. Moreover, there are indications that certain of these three organizations have influenced the thinking of the others. Therefore, no attempt is made to evaluate the relative importance of each group. Instead, the objective is an effort to arrive at a consensus of opinion regarding the issues chosen. In conjunction therewith, the pronouncements are evaluated and compared in section three.

Section four consists of an analysis of recent practice. It is hoped that the current state of affairs is thereby revealed. In addition,

an attempt is made to determine in general terms the degree to which practice conforms to the official releases of the organizations selected. Since the consolidation of foreign subsidiaries is regarded as a special case, the general situation is considered before reference is made to problems of foreign subsidiaries.

Chapters two and three do not purport to be theoretical in nature. Instead, their objective is to serve as justification for the review of theory undertaken in the subsequent chapters.

Basic Issues

During the year 1953 the committee on accounting procedure of the American Institute of Accountants requested the Research Department to submit a questionnaire to several prominent accountants to determine their views on consolidation policy. Among those submitted, the following questions were directly related to the topic under discussion.

3. What are the governing criteria in determining whether a parent's accounts should or should not be consolidated with those of its subsidiaries?

5. When a majority owned subsidiary is not consolidated, should a footnote to the parent's or consolidated statements be required (1) setting forth the parent's share of the unconsolidated subsidiary's profits or losses for the period and the parent's share of dividends declared by such subsidiary during the period, and (2) setting forth the extent to which the parent's equity in the unconsolidated subsidiary has been increased or diminished since date of acquisition as a result of profits, losses and distributions?

7. Are there any special considerations which should govern or require the preparation of "combined" statements as distinguished from consolidated statements? ("Combined" statements

here refers to consolidation of accounts of a group of companies under common control of another corporation or group of affiliated corporations or individuals.)

14. Should disclosure of the extent or degree of consolidation of a parent's subsidiaries, and a clear statement of policy followed in determining whether or not to consolidate, be made mandatory in consolidated statements?

17. Should it be required that intercompany profits resulting from sales of inventory or fixed assets to an unconsolidated domestic or foreign subsidiary be eliminated from the parent's statements?¹

There were many responses to the above questions. While there was basic agreement about the broad criteria that should govern consolidation, there was also a general reluctance to permit its rigid application. The traditional requirement of majority ownership of voting shares outstanding was frequently cited as the most important requirement. The majority also considered homogeneity of operations a basic condition precedent to consolidation. However, a minority of respondents considered the importance of this requirement to be exaggerated. The following factors were also mentioned.

. . . location and availability of subsidiary assets, material amounts of extensively secured debt in the hands of outsiders, extent of minority interests in junior and senior stocks, possibility of loss of voting control through conversions or arrears of preferred dividends, time-period elapsing between different fiscal year closing dates of parent and subsidiary, permanency of affiliation, insolvency or bankruptcy of subsidiary. . . .²

¹American Institute of Accountants--Research Department, "Some Problems Regarding Consolidated and Parent Company Statements," Journal of Accountancy, (November, 1953), pp. 571-576.

²Ibid., p. 571.

The replies to question 5 were unanimously in favor of revealing the information referred to in it. They also expressed the opinion that the method of presentation should be adapted to fit the prevailing circumstances.

Many believed that the total amount of the parent's equity in the unconsolidated subsidiaries at the balance sheet date should be revealed, if material.

There was general agreement that "combined" statements are governed by the same considerations that control consolidated statements. Thus, the opinion that intercompany accounts and transactions should be eliminated in the same manner as is done in consolidated statements was prevalent. Combined statements are justified in the following situations.

. . .where one individual owns a controlling interest in several corporations which are related in their operations. . .to present the financial position and the results of operations of a group of unconsolidated subsidiaries. . .to combine the financial statements of companies under common management.¹

A majority of those answering question 14 favored making disclosure mandatory if a significant subsidiary was omitted. The term "significant" was not defined.

The replies to question 17 were generally against a requirement of eliminating intercompany profits on the parent's statements which resulted from sales to unconsolidated subsidiaries on the grounds that profits were realized by the parent as a separate legal entity. Some favored disclosure with a preference for a reserve on the parent's or consolidated statements if profits were material.

¹Committees on Accounting Procedure and Accounting Terminology, Accounting Research and Terminology Bulletins--Final Edition (New York: American Institute of Certified Public Accountants, 1961), p. 48.

Mr. Carman G. Blough, Director of Research at the time of the preceding investigation, has commented indirectly on certain of the questions referred to above. The following quotation is related to questions three, five and fourteen.

As to the propriety of a company's not including in its consolidated statements a newly acquired subsidiary where the latter has a large funded debt in contrast to the parent, it seems to us the burden of proof should be on those who wish to omit a controlled subsidiary from consolidation, and the auditor should determine whether the reasons for a proposed omission are sound. While it is never proper to omit only those subsidiaries whose financial position would detract from the showing of the consolidated statements, there are cases in which bond indentures of a subsidiary may place such restrictions on assets and surplus that a consolidated statement including such subsidiaries might be misleading. In any case, the important information should be clearly disclosed.¹

Mr. Blough makes no reference to the significance of the subsidiary and his answer clearly states the danger inherent in permitting too much discretion in the decision to include or omit a particular subsidiary.

In reference to another situation in which a large manufacturing concern did not wish to consolidate but desired to take into its accounts its share of the net profits from the operation of a real estate corporation, Mr. Blough comments as follows.

It seems to us that a real estate subsidiary owning buildings which are used by the parent should, in most instances, be included in consolidation. . . . The company itself apparently wants the final result of consolidation

¹Carman G. Blough, Practical Application of Accounting Standards (New York: American Institute of Accountants, 1957), p. 416.

but does not want to go through the form of consolidating On the same theory, some manufacturing companies have excluded from consolidation their financing subsidiaries, as in the automobile field.

There are companies which do take up the earnings of their subsidiaries on their own books with the approval of their public accountants. However, we think in most of these cases the income is taken up by increasing the investment of the parent in the subsidiary but carrying the parent's share of the earnings directly to surplus and not permitting them to be included in the income of the parent until they have been realized by a dividend. If this procedure were to be followed, we would prefer that such subsidiary earnings be shown segregated from the parent's retained earnings and clearly designated as Undistributed Earnings of Subsidiary.¹

The preceding remarks bring into sharper focus the relevance of homogeneity and again emphasize the pitfalls of excessive discretion.

Official Pronouncements

American Institute of Certified Public Accountants.--Accounting Research Bulletin No. 51 of the American Institute of Certified Public Accountants is entitled "Consolidated Financial Statements." It is reproduced in full as Appendix I. Those parts of it relating to the topic of this thesis will be discussed in this section.

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule, ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation.²

¹Ibid., p. 420.

²Committee on Accounting Procedure, Accounting Research Bulletin No. 51 (New York: American Institute of Certified Public Accountants, 1959), p. 41.

It is apparent that the Committee regards control as the most important criterion for consolidation. It attaches considerable significance to the ownership of a majority voting interest as an indication of control but does not make it an indispensable requirement. Hence, if control is present there exists the possibility of consolidating minority owned subsidiaries without violating the pronouncement. However, a major concern of the Bulletin is with those situations in which there is majority ownership of voting shares but an obstacle to the consolidating process exists. A somewhat comprehensive list of possibilities was presented on page 9. The Committee repeats some of these circumstances in its bulletin.

Both the respondents to the poll referred to on pages 8 and 9 and the Committee advocate homogeneity of operations as a condition precedent to consolidation. Both qualify their positions sufficiently to remove this factor as a deterrent to consolidation, if so desired.

The reader should be given information which is suitable to his needs, but he should not be burdened with unnecessary detail. Thus, even though a group of companies is heterogeneous in character, it may be better to make a full consolidation than to present a large number of separate statements.¹

Bulletin No. 51 advocated disclosure of policy.

Consolidated statements should disclose the consolidation policy which is being followed. In most cases this can be made apparent by the headings or other information in the statements, but in other cases a footnote is required.²

¹Ibid., p. 42.

²Ibid., p. 42.

The Committee's position seems to be an improvement over that of the respondents who advocated mandatory disclosure only if a "significant" subsidiary is omitted from consolidation.

Among the questions asked in the poll there was none requesting selection of a particular method for recording the investment in an unconsolidated subsidiary. Nevertheless, the answers to question five revealed a tendency to reject the cost method. However, Bulletin No. 51 does state a preference.

The preferable method, in the view of the committee, is to adjust the investment through income currently to take up the share of the controlling company or companies in the subsidiaries' net income or net loss, except where the subsidiary was excluded because of exchange restrictions or other reasons which raise the question of whether the increase in equity has accrued to the credit of the group . . . The other method, more commonly used at present, is to carry the investment at cost, and to take up income as dividends are received; however, provision should be made for any material impairment of the investment, such as through losses sustained by the subsidiaries, unless it is deemed to be temporary. Where the latter method is followed, the consolidated statements should disclose, by footnote or otherwise, the cost of the investment in the unconsolidated subsidiaries, the equity of the consolidated group of companies in their net assets, the dividends received from them in the current period, and the equity of the consolidated group in their earnings for the period; this information may be given in total or by individual subsidiaries or groups of subsidiaries.¹

While not rejecting the cost method of recording investment in unconsolidated subsidiaries in so many words, the Committee has accomplished this result by the conditions it attaches to the use of this method. The suggestion that a provision should be made for losses reflects a basic

¹Ibid., pp. 46-47.

uneasiness about the cost method and is inconsistent with its use. The disclosures recommended in case the cost method is used provide sufficient information to convert the investment account to the recommended method. If the recommended method is used, the justification for not consolidating is considerably weakened. If, by so doing, a parent company takes up its share of the subsidiary's increase or decrease in net assets since the date of acquisition of its interest in the subsidiary, it is one step closer to merging the accounts of the subsidiary with its own.

It will be remembered that the poll revealed a disinclination to eliminate intercompany profits from sales to unconsolidated subsidiaries. This attitude was based upon the contention that an unconsolidated subsidiary is a separate business entity. The Committee does not seem to share this opinion.

Also, appropriate recognition should be given to the necessity for an adjustment for intercompany gains or losses on transactions with unconsolidated subsidiaries. If sales are made to unconsolidated subsidiaries and the investment in the subsidiaries is carried at cost plus the equity in undistributed earnings, an elimination of unrealized intercompany gains and losses should be made to the same extent as if the subsidiaries were consolidated. The same applies where intercompany sales are made by the unconsolidated subsidiaries. If, however, the investment is carried at cost, it is not necessary to eliminate the intercompany gain on sales to such subsidiaries, if the gain on sales does not exceed the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries. If such gain is material, it should be appropriately disclosed. Where the sales are made by the unconsolidated subsidiaries to companies included in the consolidated group, the intercompany gains or losses should be eliminated in arriving at the amount of the equity in the undistributed earnings of the unconsolidated subsidiaries which will be disclosed in a footnote or otherwise.¹

¹Ibid., pp. 47-48.

The seeming concession under the circumstance where the investment is carried at cost and sales are made to unconsolidated subsidiaries does not exist as a result of the failure to adjust the investment account for the parent's share of undistributed earnings.

Bulletin No. 51 advocated the preparation of combined statements under approximately the same circumstances as the poll's respondents did. Its suggestions in regard to the mechanics of preparation were almost identical to those of that group.

The Bulletin again reveals its uneasiness about unconsolidated subsidiaries in the following recommendation.

Where the unconsolidated subsidiaries are, in the aggregate, material in relation to the consolidated financial position or operating results, summarized information as to their assets, liabilities and operating results should be given in the footnotes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate.¹

American Accounting Association.--The attitude of the American Accounting Association towards the general subject of consolidation is expressed in Supplementary Statement No. 7, Consolidated Financial Statements. It is reproduced in full as Appendix II. It suggests consolidation under the following conditions:

In the absence of special circumstances, consolidated statements are useful representations of financial position and results from operations when a dominant central financial interest in two or more companies exists and is accompanied by administrative control of their activities and resources.²

¹Ibid., p. 48.

²Committee on Concepts and Standards, "Consolidated Financial Statements--Supplementary Statement No. 7," Accounting Review (April, 1955), p. 194.

The Statement attempts to define "dominant central financial interest."

Usually the presence of this interest is clear-cut and recognizable. . . . When, however, its existence is not obvious its evaluation involves consideration of the amount and type of share ownership among affiliates, representation on the board of directors, restrictive clauses in bond and share contracts, restrictive legislation, etc. . . . In most cases, however, ownership of a majority of the voting shares outstanding is sufficient to establish a prima facie case that a dominant central financial interest exists.¹

Thus, its position in regard to control seems very similar to that of the American Institute of Certified Public Accountants and it makes the customary reservations about the universal applicability of this criterion for consolidation. However, it does add the stipulation of administrative control. If administrative control exists in conjunction with a dominant central financial interest there would seem to be little objection to consolidation even though ownership of a majority of the voting shares was not present.

Administrative control implies that each constituent unit is operated as if it were a department or branch of a larger entity.²

The two organizations are substantially in agreement about the question of homogeneity.

An affiliate, to be included in consolidation, must ordinarily manufacture a product or perform a function or render a service which contributes directly to the activities in which the overall enterprise is primarily

¹Ibid., pp. 194-195.

²Ibid., p. 195.

engaged. . . . In view, however, of the marked trend toward diversification of activities on the part of American businesses, care should be exercised in the use of the "primary activity" of the enterprise as a criterion of inclusion or exclusion.¹

The stand of the Association on the question of majority-owned affiliates which are omitted from consolidation is considerably different from that of the Institute.

If a majority-owned affiliate is omitted from consolidation, reasons for the exclusion should be given. . . . Where the excluded company is significant in size or other aspect, appropriate disclosure should be made of the parent's share of (1) the subsidiary's profits or losses for the current accounting period, (2) the dividends declared by the subsidiary during such period, and (3) the subsidiary's undistributed earnings from date of acquisition. Under these circumstances, a strong presumption exists that separate statements of the subsidiary would accompany the consolidated statements.²

The request for reasons for exclusion places the burden of proof where it belongs, as advocated by Mr. Blough. It is unfortunate that the term "significant" has been used in this context. The objection to it is the usual one of lack of precision. The supplementary information requested in the event of exclusion is not radically different than its counterpart in Bulletin No. 51 of the Institute. However, it is recommended regardless of the method used in accounting for the investment in the subsidiary. This enables conversion from the cost to the adjusted method of carrying investment or the opposite if so desired. Moreover, the information, although not radically different, is broader in scope and, therefore,

¹Ibid., p. 195.

²Ibid., p. 196.

affords greater flexibility in its use. Finally, dividends declared rather than dividends received would seem to be the more appropriate figure. The Association does not advocate one method of accounting for investment in preference to the other, as does the Institute, and it does not mention the possibility of elimination of profits or losses on transactions between a parent and unconsolidated subsidiary.

Supplementary Statement Number 7 suggests disclosure of policy. It does not suggest methods as does Bulletin No. 51 but it does submit a reason, which may be more important.

Published statements should disclose the principles of consolidation actually followed. Such disclosure is particularly important at the present time because of the diversity of rules and standards in current use.¹

Supplementary Statement No. 7 refers to combined statements only incidentally so that it is impossible to comprehend the Committee's attitude toward them.

United States Securities and Exchange Commission.--Regulation S-X and the Accounting Series Releases express the views of the Commission on the subject of consolidated statements. Article 4, Rules 4-01 through 4-13, are reproduced in full as Appendix III. Article 4, Rule 4-02, delineates the conditions necessary for the preparation of consolidated statements.

The registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary.²

¹Ibid., p. 196.

²United States Securities and Exchange Commission, Regulation S-X, Form and Content of Financial Statements (Washington, D.C.: U.S. Government Printing Office, 1962), p. 7.

This is a minimum condition and does not rule out the possibility of not consolidating a majority-owned subsidiary.

Instead the language of Rule 4-02 should be considered as setting a test which the specific principles adopted in a given case must meet. The specific principles followed should be objective and definite, such as, for example, that the registrant includes in consolidation all wholly owned subsidiaries, or all domestic wholly owned subsidiaries or all wholly owned manufacturing subsidiaries.¹

This is the least complicated statement of this requirement thus far reviewed. It probably permits greater latitude than the pronouncements of either the American Institute of Certified Public Accountants or the American Accounting Association.

Group or combined statements are condoned by Rule 4-03.

For majority owned subsidiaries not consolidated with the registrant there may be filed statements in which subsidiaries are consolidated or combined in one or more groups pursuant to principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the group or groups. If it is essential to a properly summarized presentation of the facts,² such consolidated or combined statements shall be filed.

Just as Regulation S-X leaves the decision of whether to consolidate or not to the registrant if the minimum requirement has been fulfilled, it leaves the decision of whether to prepare combined statements up to him.

¹United States Securities and Exchange Commission, Accounting Series Releases--Release No. 32, April 28, 1942 (Washington, D.C.: U. S. Government Printing Office, 1956), p. 80.

²Regulation S-X, op. cit., p. 7.

Beside disclosure of consolidation principles followed a statement is required in regard to consistency.

As to each consolidated statement and as to each group statement of unconsolidated subsidiaries, a statement shall be made as to whether there have been included or excluded any persons not similarly treated in the corresponding statement for the preceding fiscal period filed with the Commission.¹

There is a minimum amount of information required if subsidiaries, as defined, are not consolidated.

A statement shall be made of the amount of any difference between the investment of the parent and its consolidated subsidiaries, as shown by their books, in the unconsolidated subsidiaries and fifty-percent owned persons for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, and fifty-percent owned persons, as shown by the books of the latter.²

Essentially, this is the familiar "goodwill" or "surplus from consolidation," unless otherwise disposed of, and is required only if the statements of the unconsolidated subsidiaries are also filed. A separate schedule requires additional information regarding dividends from affiliates and the parent's equity in profits or losses of affiliates.

The proportion of the sum of, or difference between, current earnings or losses and the dividends declared or paid by the unconsolidated subsidiaries required to be included in the schedule prescribed by rule 12-17 that is applicable to the parent and its consolidated subsidiaries shall be set forth in a note to each consolidated profit and loss statement.³

¹Ibid., p. 7.

²Ibid., p. 7.

³Ibid., p. 8.

The question of the elimination of profits or losses on transactions between a parent and an unconsolidated subsidiary is not considered.

The importance assigned to consolidated statements by the Securities and Exchange Commission is revealed in the following comments.

The Securities and Exchange Commission requires parent company statements in certain circumstances, but perhaps it is significant that in the case of financial statements included in proxy statements, where the rules give the staff of the Commission some latitude they rarely require the statements of the parent. In the summary of earnings which is generally regarded as the "meat" of a prospectus, consolidated figures are usually considered sufficient.¹

Evaluation and Hypotheses.--The five questions asked at the beginning of this chapter are excellent questions as far as they go. The answers to these questions reflect the diversity of opinion that is characteristic of the profession. This is a favorable aspect and is the springboard to progress in any field of endeavor. However, the answers also reveal a tendency towards traditional patterns of thought. This is not to be condemned when it serves the purpose of providing a basis for continued development. However, there is a point at which this tendency begins to stifle progress. Further investigation is necessary to determine whether that point has been reached.

Accounting Research Bulletin No. 51 seems to be largely in agreement with the opinions of practitioners as revealed in their answers to the poll. If so, it shares the criticism directed at them.

¹John Peoples, "The Preparation of Consolidated Statements," Journal of Accountancy (August, 1957), p. 33.

Supplementary Statement No. 7 appears to possess greater logic than Bulletin No. 51. It also reveals a tendency to proceed beyond the limits of conventional thought. However, it is the product of an academic organization and perhaps has not had as much influence on accounting practice as the Bulletin.

The purpose of Bulletin S-X and the Accounting Releases Series is special. They state the requirements for the form and content of financial statements required to be filed under the Securities Act of 1933, the Securities Exchange Act of 1934 and supplemental or periodic reports under Sections 13 and 15 of the Securities Exchange Act of 1934. However, the influence of these publications upon general accounting practice has undoubtedly been substantial.

All three regulatory bodies appear to be in substantial agreement on most major issues. Hence, comment directed at one of them may properly be applied to all three.

The remainder of this chapter will be devoted to an examination of accounting practice in the area of consolidation of domestic subsidiaries. The presumption is that Bulletin No. 51 provides guidance for performance in the field. It has already been suggested that the reverse may be true. In either case, the hypothesis is that in a given situation almost any alternative is permitted so long as it is generally recognized as accepted accounting practice.

Accounting Practice

Since 1946 the American Institute of Certified Public Accountants has published a study of the accounting aspects of financial reports released annually by 600 industrial companies, entitled Accounting Trends and Techniques. It is assumed that this sample fairly represents the accounting practices of industrial corporations in general. Data for the years 1951, 1955 and 1960 will be presented for the purpose of indicating trends. Data for the year 1960 will be examined in greater detail to illustrate specific points. The year 1951 is used instead of the year 1950 because of changes in the methods of accumulating data initiated in 1951.

Before proceeding with a detailed analysis of consolidation practices, the importance attached to consolidated statements by the companies preparing them is illustrated by the fact that of 329 companies included in a recent survey, only five submitted statements of the parent company.¹ The 329 companies responded to a poll of approximately 400 companies presenting consolidated statements in the annual reports issued in 1954. Their reports are regularly included in Accounting Trends and Techniques.

The following tabulation is indicative of certain trends. Generally, they are self-explanatory. Attention should be focused on the increase in partially consolidated financial statements for reasons which will be presented later.

¹American Institute of Accountants--Research Department, Survey of Consolidated Financial Statement Practices, (New York: American Institute of Accountants, 1956), p. 10.

Table II.--Companies Preparing Consolidated Statements

	<u>1951</u>	<u>1955</u>	<u>1960</u>
Fully consolidated financial statements	260	251	258
Partially consolidated financial statements	182	210	258
Unconsolidated financial statements	<u>41</u>	<u>38</u>	<u>20</u>
Total companies having subsidiaries	483	499	536
Companies having no subsidiaries	<u>117</u>	<u>101</u>	<u>64</u> ¹
Total	600	600	600 ¹

Before a detailed analysis of the above reported figures is presented, it is appropriate to consider the definition of the term "subsidiary" as used in the studies.

For the purpose of this tabulation, a company has been considered a subsidiary if it is so described in the annual report, or if it is stated therein to be over 50 percent owned.²

The definition is a curious amalgam of liberal and conservative thought. Its conservative aspect has been discussed in the first part of this chapter. Part of the definition is consistent with that aspect. Its liberal aspect would permit any percentage of ownership to suffice if the company was described as a subsidiary. The possibility of the existence of a parent-subsidiary relationship without majority ownership has been referred to before. It will be discussed in greater detail in a subsequent chapter. It is assumed that all or almost all the companies described as subsidiaries are more than fifty percent owned.

¹The 1963 issue of Accounting Trends and Techniques reveals that 39 more companies partially consolidated in 1962, 23 fewer companies fully consolidated and 17 fewer companies had no subsidiaries. Continuing concern over the reasons for partial consolidation appears warranted.

²American Institute of Certified Public Accountants, Accounting Trends and Techniques (New York: American Institute of Certified Public Accountants, 1961), p. 137.

The topic of disclosure was developed to a considerable extent earlier. If Bulletin No. 51 has been used as a guide, its weakness on this point is exemplified by the following comments.

There is no uniform procedure followed by the survey companies with regard to the amount of disclosure given to the basis of inclusion or exclusion of the accounts of subsidiary companies in consolidation. . . In most instances, the basis of consolidation is indicated rather than stated; usually the basis of consolidation can be determined only by observing the nature of the unconsolidated subsidiaries or the fact that there is no investment in unconsolidated subsidiaries.¹

Since a large part of the remainder of this chapter will be devoted to a summary and analysis of the reasons for not consolidating subsidiaries, as defined, its accuracy will suffer to some unknown extent from the lack of disclosure. Despite this fault, the conclusions should be sufficiently valid, as a result of the alternative methods used, to permit a sufficiently accurate evaluation of practice.

A further breakdown of the figures presented for 1960 follows.²

Table III.--Companies With Domestic and Foreign Subsidiaries, 1960

<u>Consolidation Policy</u>	<u>Domestic Only</u>	<u>Domestic and Foreign</u>	<u>Foreign Only</u>	<u>Not Indicated</u>	<u>Total Companies</u>
Fully consolidated financial statements	104	128	17	9	258
Partially consolidated financial statements	28	223	7	-	258
Unconsolidated financial statements	<u>9</u>	<u>2</u>	<u>9</u>	<u>-</u>	<u>20</u>
Total Companies having subsidiaries	141	353	33	9	536
Companies having no subsidiaries	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u>64</u>
Total					600

¹Ibid., p. 137.

²Ibid., p. 138.

Unfortunately, the reasons why policies of full consolidation or no consolidation at all are followed are not tabulated. It is probably safe to presume that certain companies consolidate fully under circumstances which would result in only partial consolidation or unconsolidation by other companies. Thus, the principle of homogeneity of operations as a prerequisite to consolidation is undoubtedly violated by several companies which consolidated fully. Just the opposite is probably true of some companies which do not consolidate at all. It may even be, as suggested before, that the rule of majority ownership is not fully accepted among some of the companies which follow a policy of complete consolidation and it is just as likely that certain companies possessing majority ownership do not consolidate. However accurate they are, these are only speculations, but it is possible to support the contentions made in this paper by listing the reasons for partial consolidation.

Of 141 companies owning domestic subsidiaries only, 28 partially consolidated those subsidiaries, as follows:¹

Table IV.--Partial Consolidation--Domestic Subsidiaries Only

<u>Reason for Not Consolidating</u>	<u>Number of Companies</u>
Non-homogeneous operations	12
Not wholly owned, active	7
Not significant, principal and active	4
Basis not indicated	<u>5</u>
Total	28

If the bases were indicated, it is probably that several of the final group of five companies would be classified among the other groups. The word active is self-explanatory and significant and principal probably have

¹Ibid., p. 138.

somewhat similar meanings in most instances. The major reasons for not consolidating, then, are lack of homogeneity and lack of complete ownership. The following note is an example of disclosure under conditions of non-homogeneity.

City Stores Company

Notes to Financial Statements

Note A: Principles of Consolidation--The accounts of all subsidiaries are included in the accompanying consolidated financial statements, except those of certain real estate subsidiaries, the investments in which are included in the accompanying statement of financial condition at amounts equal to the net assets of such subsidiaries.¹

Real estate subsidiaries are frequently omitted from consolidation because they are considered non-homogeneous. Mr. Blough's comments about the propriety of the omission of real estate subsidiaries on page 11 are pertinent.

Of 353 companies owning domestic and foreign subsidiaries, 223 partially consolidated them. Among the 223 companies were 83 companies which consolidated all domestic subsidiaries, whether or not they were wholly owned and/or homogeneous. The reasons for partial consolidation among the remaining 140 companies owning domestic subsidiaries are listed below.²

Table V.--Partial Consolidation--Domestic and Foreign Subsidiaries

Not wholly owned, active	56
Non-homogeneous operations	32
Not significant, principal and active	15
Lack of voting control or fixed % of ownership	7
Other basis	6
Basis not indicated	<u>24</u>
Total	140

¹Ibid., p. 139.

²Ibid., p. 138.

Probably several of the companies whose bases were not indicated would be reclassified in other categories if more information was available. It is worthwhile to note that the first two reasons have exchanged places when this summary is compared with the preceding summary. It seems that ownership of foreign as well as domestic subsidiaries, as contrasted to ownership of domestic subsidiaries only, results in the placement of greater emphasis on the percentage of voting stock held rather than on homogeneity as a criterion for consolidation. No reason for this trend is advanced but it is surmised that a reluctance to include foreign subsidiaries merely because they are not located in the United States has had its effect on the inclusion of domestic subsidiaries as well, through the mechanism of a general increase in all the requirements for consolidation. This contention will be examined more thoroughly in the next chapter. It is sufficient to comment here that, if this is a correct appraisal, it is indicative of perhaps greater flexibility than is necessary.

Moreover, it is always appropriate to inquire whether majority ownership is not sufficient to insure control. Both Bulletin No. 51 and Supplementary Statement No. 7 suggest that it is not only under unusual circumstances. For this to be true of 56 out of 140 companies seems highly unlikely. The following is an example.

PHILIP MORRIS INCORPORATED
Notes to Financial Statements

Note 1: Principles of Consolidation -- the consolidated financial statements include the accounts of all wholly-owned active subsidiaries. Effective January 1, 1960, the Company changed its accounting practice (1) to include in the consolidated financial statements the accounts of all wholly-owned foreign subsidiaries, (2) to include in consolidated earnings the equity of the Company in net earnings of unconsolidated foreign subsidiaries more than 50% owned,

less a reserve for federal taxes which may be payable on these earnings in the event of their remittance. For comparative purposes, 1959 earnings have been restated on the same basis.

The equity of the Company in net assets of unconsolidated foreign subsidiaries at December 31, 1960, exceeded the cost (\$5,848,437) thereof by \$1,709,640.

In 1960, the Company by an exchange of its stock acquired the net assets of A.S.R. Products Corporation. For accounting purposes, this transaction was treated as a pooling of interests; consequently, the accompanying balance sheets and statements of earnings and surplus include the accounts of both companies for each period shown.¹

When combined, the two tables yield the following results:

Table VI.--Partial Consolidation--Summary

<u>Reason for Not Consolidating</u>	<u>Number of Companies</u>
Not wholly owned, active	63
Non-homogeneous operations	44
Not significant, principal and active	19
Lack of voting control or fixed % of ownership	7
Other basis	6
Basis not indicated	29
Total	168

Comments have been made about the first two reasons. Reason three is always open to question on the grounds that there is no universally accepted definition of its terms. Reasons four and five are ignored because of the infrequency of their occurrence. Reason six has been discussed previously.

There is a distinct possibility of inconsistencies between companies. For example, one company may include a subsidiary that is wholly owned although its operations are not homogeneous with its own, whereas another company in much the same situation may exclude a wholly owned subsidiary

¹Ibid., p. 139.

because its operations are not homogeneous. Other more complicated examples are possible but they would only serve to illustrate the same point. It is difficult to provide illustrations of such situations primarily because the terms used are difficult to define. For example, the word "homogeneous" may be subjected to different interpretations.

The following table permits a comparison of the reasons for not consolidating in the year 1955 with those presented in the previous table. There were minor changes in the methods of presentation between the two years which should have no appreciable effect on the comparison.

Table VII.--Partial Consolidation--Domestic Subsidiaries, 1955

Not wholly owned, active	46
Non-homogeneous operations	25
Not significant, principal and active	13
Lack of fixed percentage of ownership	6
Other basis	3
Basis not indicated	<u>30</u>
Total	123

There are 45 fewer companies in the above summary. The major reason for this discrepancy is a decrease in the number of companies having no subsidiaries from 101 in 1955 to 64 in 1960. There is no change in the ranking of reasons between the two years.

Appendices IV and V supply the information necessary for the accumulation of the figures presented thus far. Appendix VI provides information of the same general nature but accumulated according to somewhat different classifications for several previous years.

It is appropriate to consider possible substitutes for consolidated statements. There is no other way of providing the detailed information supplied by consolidated statements. However, the investment account

reveals certain information in summary form. If the account is recorded at cost, it is of little use as an alternative. If it has been adjusted for the parent's share of undistributed subsidiary earnings since the date or dates of acquisition of the subsidiary, it is more useful. If additional information is provided in the footnotes to the financial statements of the parent company, even more knowledge is acquired. The appropriate recommendations of Bulletin No. 51 may be referred to at this time. Briefly, it stated a preference for the adjusted method and requested the revelation of data pertaining to the profits, dividends and net worth of the subsidiary if the cost method was used.

In view of these suggestions, Appendix VII provides an interesting summary of practice. In the year 1960, of 278 companies either partially consolidating or not consolidating their subsidiaries at all, 266 presented an investment account in their balance sheets. It is interesting to speculate about the lack of this account among 12 of the companies. It is likely that in some instances it was reduced to a zero balance and then removed entirely from the records, with or without justification.

Of the 266 companies, almost all used the standard account title or a recognizable variation thereof. However, the merger of investment with advances or receivables may lead to erroneous conclusions, particularly if the amounts of the advances and/or receivables are not revealed elsewhere.

An excess of 19 bases of evaluation over the number of companies listing investment accounts in their balance sheets probably means that some

of the companies used more than one basis of valuation. The apparent lack of consistency may or may not be justified but it certainly is open to question.

If criticism is appropriate, there seems to be no better place to apply it than to the bases of valuation used. Among 285 bases, only 30 may be interpreted as probably complying with the preference stated in Bulletin No. 51 and another 16 as possibly complying with it. These are items K and D, respectively, in Appendix VII. Doubt is expressed because "equity in net assets" may not be the same as cost plus the parent's share of undistributed subsidiary earnings since the date of acquisition. Similarly, "cost adjusted for equity in earnings" may not be identical to cost adjusted for equity in undistributed earnings. If these qualifications should prove to be unnecessary, there are still 239 examples of deviation from suggested policy. While 170 of these are some variation of cost, which is permitted by the Bulletin, it is extremely doubtful that the additional information suggested by the Bulletin in the event that a cost basis is used, has been provided even by a majority of the companies involved. Finally, there are 44 situations where no basis of valuation is indicated. On the basis of this evidence, it is concluded that the choice of the investment account, even with supplementary information provided, as a substitute for consolidated statements, is a poor choice indeed.

There are frequent references to combined statements in the first half of this chapter. These statements, the statements of the subsidiary

itself, and statements pertaining to the subsidiary but issued by the parent are all sources of additional information, but it is doubtful that they can adequately substitute for consolidated statements. Part C of Appendix VIII reveals that 46 additional statements were prepared by 29 companies owning domestic subsidiaries. This is a meager output when it is recalled that 494 of the survey companies owned domestic subsidiaries. They are of little use in presenting information not otherwise supplied.

Conclusion

From the evidence provided in the fourth section of the second chapter, the following conclusions seem to be warranted. It appears that Bulletin No. 51 and, to a lesser extent, Supplementary Statement No. 7 and Regulation S-X, are, at best, so non-directive as to be of little value as guides in formulating policies of consolidation. At worst, there is a possibility that they merely reflect existing practice. If so, they may condone practices which possibly have little or no basis in theory. If the objective of consolidated statements is the presentation of the financial position and results from operations of an economic entity, a clear definition of the term is necessary. The creation of an artificial entity results in misleading figures. This possibility exists under the conditions described above.

Of course, a certain amount of flexibility in the preparation of financial statements is desirable. No rigid code can anticipate all the possibilities that may require depiction in a balance sheet or in an income statement. The question to be answered asks how much flexibility should be permitted. While answering it may be difficult, avoidance can

be harmful to the profession as well as to the reader of the statements.

If so little uniformity exists in the policies guiding the preparation of consolidated statements including only domestic subsidiaries, it is possible that even less can be expected of the policies relating to foreign subsidiaries because of added complicating factors. This hypothesis will be tested in chapter three.

CHAPTER III

CONSOLIDATION OF FOREIGN SUBSIDIARIES

Introduction

The organizational structure of Chapter III is similar to that of Chapter II. The material discussed in Chapter II is also applicable to the case of the foreign subsidiary. However, there are certain problems which arise in connection with the consolidation of foreign subsidiaries which are not encountered when domestic subsidiaries are considered. The current chapter attempts to illustrate those problems.

Basic Issues

Among the other factors thought to deserve consideration in the answers to question 3 on page 8 of this thesis were the following:

. . . the existence of currency and other restrictions upon the operations of foreign subsidiaries, control by a foreign or domestic government, location and availability of subsidiary assets. . . .¹

Under circumstances otherwise favorable to consolidation the presence of one of the above factors may justify a decision not to consolidate, according to the poll's respondents. The fundamental question seems to be whether or not the subsidiary assets are available to the parent company at all times. Subsidiary assets usually may be realized in the form of dividends and dividends are ordinarily paid in cash. Hence, there is concern expressed over currency and other restrictions.

¹"Some Problems Regarding Consolidated and Parent Company Statements," op. cit., p. 571.

The poll contained a question relating to the statements of foreign subsidiaries.

4. When foreign companies are consolidated with domestic companies, is a footnote showing only the amount of net corporate assets represented by foreign items adequate, or should the detail of the foreign assets and liabilities be given?¹

The answers to the above question revealed a general reluctance to consolidate foreign subsidiaries. In those cases where consolidation was effected it was thought inappropriate to indicate details. However, if disclosure was necessary, the composition and materiality of foreign items would govern its form and degree. Any doubt as to the availability of foreign assets probably should result in a condensed summary of foreign assets and liabilities in geographic form.

Official Pronouncements

American Institute of Certified Public Accountants.--The position of the Institute is stated in Chapter 12 of Accounting Research Bulletin No. 43. Appropriate sections are reproduced as Appendix IX. The doubts expressed by practitioners are reiterated by the Committee on Accounting Procedure.

4. A sound procedure for United States companies to follow is to show earnings from foreign operations in their accounts only to the extent that funds have been received in the United States or unrestricted funds are available for transmission thereto. Appropriate provision should be made also for known losses.

6. As to assets held abroad, the accounting should take into consideration the fact that most foreign assets stand in some degree of jeopardy, so far as ultimate realization by United States owners is concerned.²

¹Ibid., p. 572.

²Committee on Accounting Procedure, Accounting Research Bulletin No. 43--Restatement and Revision of Accounting Research Bulletins (New York: American Institute of Accountants, 1953), pp. 111-112.

After urging caution in decisions regarding the consolidation of foreign subsidiaries, the Committee proposes the following alternatives:

9. The following are among the possible ways of providing information relating to such foreign subsidiaries:

(a) To exclude foreign subsidiaries from consolidation and to furnish (1) statements in which only domestic subsidiaries are consolidated and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein. The total amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated.

(b) To consolidate domestic and foreign subsidiaries and to furnish in addition the summary described in (a) (2) above.

(c) To furnish (1) complete consolidated statements and also (2) consolidated statements for domestic companies only.

(d) To consolidate domestic and foreign subsidiaries and to furnish in addition parent company statements showing the investment in and income from foreign subsidiaries separately from those of domestic subsidiaries.¹

The exact degree of jeopardy referred to in paragraph 6 above necessary to warrant exclusion of foreign subsidiaries from consolidated statements is not specified. The range of alternative presentations is broad and selection is a matter of personal preference.

The effect of the above quotations is to create one more exception to the majority ownership and homogeneity rules for consolidation, that of location outside the boundaries of the United States. Its most

¹Ibid., pp. 112-113.

frequent mode of expression is a concern over restrictions, primarily those related to currency convertibility. It would seem that the Committee and most practitioners are in agreement on these points.

American Accounting Association:--The position of the American Accounting Association is expressed in the following manner.

(4) With disturbed conditions in foreign countries, which may take the form of exchange restrictions or unstable political or economic conditions, it may be desirable to omit some or all foreign subsidiaries from consolidation. In any case, appropriate disclosure of the results of foreign operations and of their status in the consolidated statements should be made.¹

Again there seems to be fear of loss of control of subsidiary assets with vagueness as to the alternative routes to jeopardy except for the reference to exchange restrictions. Similarly, there is no statement of theoretical justification for the position taken. Statement presentation and disclosure are even more a matter of personal preference in Statement No. 7 than they were in Bulletin No. 43. However, the position of the Association in regard to the omission of majority-owned affiliates from consolidation and disclosure of principles of consolidation as explained on pages 17 and 18 of this thesis must be referred to to place the previous remarks in proper perspective.

United States Securities and Exchange Commission.--Rule 4-02, Article 4, of Regulation S-X is the source of the following statements.

¹Statement No. 7, "Consolidated Financial Statements--Supplementary Statement No. 7," op. cit., p. 195.

(c) Consolidation of foreign subsidiaries--Due consideration shall be given to the propriety of consolidating with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign currencies. If consolidated, disclosure should be made as to the effect, insofar as this can be reasonably determined, of foreign exchange restrictions upon the consolidated financial position and operating results of the registrant and its subsidiaries.¹

In general, the comments made about Bulletin No. 43 and Statement No. 7 are applicable here.

Evaluation and Hypotheses.--There seems to be considerable agreement among the regulatory organizations on the subject under consideration. Apparently there is no fundamental schism between their collective opinions and those of the practitioners. It is anticipated that the requirements for the consolidation of foreign subsidiaries will be more stringent than they are for their domestic counterparts as a result of the prevailing attitudes expressed. Again it is hypothesized that almost any alternative method of statement presentation is permitted so long as it is generally recognized as acceptable accounting practice.

Accounting Practice

As before, the sources of the data presented in this section of the chapter are the various editions of Accounting Trends and Techniques and the reservations and comments expressed on pages 24 through 35 of this thesis are generally applicable here. Reference to the tabulation presented

¹Regulation S-X, op. cit., p. 7.

on page 26 is necessary for full comprehension of the following figures.

Of the 386 companies owning domestic and foreign subsidiaries or foreign subsidiaries only, 230 partially consolidated their subsidiaries.

Table VIII.--Partial Consolidation - Foreign Subsidiaries, 1960

<u>Reason for Not Consolidating</u>	<u>Number of Companies</u>
Geographic location or geographic location plus other factors	72
All excluded	57
Not wholly owned, active	32
Non-homogeneous operations	17
Not significant, principal and active	8
Lack of voting control or fixed % of ownership	7
Other basis	8
Basis not indicated	29
Total	230

It is probably true that if the basis were indicated, most of the 29 companies in the last category could be reclassified according to other descriptions in the summary. The third and fourth reasons have been discussed to a sufficient extent in Chapter II to warrant their dismissal. The fifth, sixth and seventh reasons are judged immaterial.

A comparison of the tabulation with the summary presented on page 30 reveals that the same reasons exist here as there and that the rankings of reasons are identical, with the exceptions of reasons one and two which were not present in the earlier illustration. In short, "geographic location" and "all excluded" were not given as reasons for the exclusion of domestic subsidiaries. It is significant that the first two descriptions account for more than half of the foreign subsidiaries excluded from consolidation. Their existence could logically be anticipated from the excerpts

quoted earlier in the chapter. It can hardly be asserted that "all excluded" is an explanation and it is also difficult to justify exclusion on the basis of geographic location alone.

There are undoubtedly many subsidiaries that are majority owned and whose operations are homogeneous with those of the parent and/or the consolidated group included among these 129 cases. Of course, the possibilities of inconsistencies in policy between consolidated groups in relatively similar circumstances exists and there is an increased likelihood of inconsistencies within the same consolidated group when inter-temporal comparisons are made, as a result of the greater amount of latitude permitted when foreign subsidiaries exist.

Appendices V and VI reveal that the ranking of reasons for the exclusion of foreign subsidiaries from consolidated statements have not changed significantly for several years.

An example of exclusion based upon geographical location is provided by Deere & Company.¹

DEERE & COMPANY
Balance Sheet
Investments and advances to subsidiaries
not consolidated (Note 1).....\$80,095,588

Note 1: All wholly-owned United States and Canadian subsidiaries except John Deere Credit Company are consolidated herein. A balance sheet of John Deere Credit Company is shown separately on Page 25.

The investments in and advances to unconsolidated subsidiaries as of October 31, 1960 and 1959, carried at cost less reserves, are summarized as follows:

¹Accounting Trends and Techniques, op. cit., p. 139.

1960

John Deere Credit Company	\$40,521,734
John Deere Intercontinental, S.A. (Incorporated in Venezuela)	23,743,546
John Deere-Lanz A.G. (Incorporated in West Germany)	14,385,406
John Deere S.A. (Incorporated in Switzerland)	1,444,902
Total carrying value	\$80,095,588

The Continental Oil Company excludes all foreign subsidiaries from its consolidated statements.¹

CONTINENTAL OIL COMPANY

Balance Sheet

Investments, Advances and Other Assets:

Subsidiaries at cost less reserves of
\$32,409,378 in 1960 and
\$17,595,083 in 1959 (Note 1) \$136,835,710

Note 1: It is the policy of the Company to consolidate the accounts of all 100%-owned subsidiaries operating in the United States.

The Company's equity in the net assets of unconsolidated subsidiaries at December 31, 1960 and in their 1960 earnings based upon their financial statements is summarized below:

December 31, 1960

	<u>Investments and advances</u>	<u>Equity in net assets plus advances</u>	<u>Equity in 1960 earnings (losses)</u>
Hudson's Bay Oil & Gas Company Ltd. (67.77% owned)	\$ 30,673,841	\$ 46,303,175 (a)	\$ 860,001 (a)
San Jacinto Petroleum Corp. (81.98%-owned) (b)	55,197,245	30,505,945 (a)	(1,441,952) (a)
Companies operating abroad (100% owned)	79,511,825	79,535,713 (c)	(10,364) (c)
Other Subsidiaries	3,862,177	7,627,329	1,162,493 (d)
	<u>169,245,088</u>	<u>\$163,972,162</u>	<u>\$ 570,178</u>
Less reserves	<u>32,409,378</u>		
	\$136,835,710		

¹Accounting Trends and Techniques, op. cit., pp. 137-139.

Deere & Company did not consolidate a subsidiary located in Switzerland. Continental Oil Company did not consolidate a subsidiary located in Canada. In contrast, Gruen Industries, Inc., consolidated subsidiaries located in both countries.

GRUEN INDUSTRIES, INC.
Notes to Financial Statements

Note 1: Principles of Consolidation--The consolidated statements include the accounts of the Company and its wholly-owned foreign subsidiaries.

With respect to the Company's consolidated Swiss and Canadian subsidiaries, the amounts of net noncurrent assets have been translated into United States currency generally at the approximate exchange rates in effect at the time of acquisition. Net current assets have been translated generally at appropriate rates of exchange.¹

Bulletin No. 43 advocates the preparation of summaries of assets and liabilities, income and losses for the year, and the parent company's equity therein, particularly if the foreign companies are not consolidated and as an alternative if the foreign subsidiaries are consolidated.

"Thirty-two additional statements applicable to foreign subsidiaries were presented by 17 survey companies in their 1960 reports."²

A total of 386 of the 600 surveyed companies owned foreign subsidiaries. Nine companies presented supplementary schedules of foreign investments in their 1960 reports.³ It appears that the suggestions of Bulletin No. 43 in reference to the presentation of information relative to foreign subsidiaries are largely ignored in practice.

¹Accounting Trends and Techniques, op. cit., p. 137.

²Ibid., p. 20 (also Appendix VIII).

³Ibid., p. 21.

Bulletin No. 43 suggests the use of reserves under certain conditions.

5. Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant, and they should be reserved against to the extent that their realization in dollars appears to be doubtful.

11. Provision should be made, ordinarily by a charge against operations, for declines in translation value of foreign net current and working assets (unrealized losses). Unrealized gains should preferably be carried to a suspense account, except to the extent that they offset prior provisions for unrealized losses, in which case they may be credited to the account previously charged.¹

The contradiction in paragraph 11 is a reflection of the basically conservative attitude of the Institute commented on in Chapter II.

Forty-three companies disclosed 50 reserves in their balance sheets. . . .

Detailed information regarding increases or decreases in these reserves was given in only a few instances, generally in the notes to financial statements or in the president's letter.²

Of the 50 reserves, 35 were essentially provisions against operational losses, 7 against foreign exchange losses and 8 against statutory requirements.³ Despite the fear of losses expressed by the Institute, only 43 companies of 386 owning foreign subsidiaries provided for them. It is

¹Accounting Research Bulletin No. 43--Restatement and Revision of Accounting Research Bulletins, op. cit., pp. 111-113.

²Accounting Trends and Techniques, op. cit., p. 109.

³Ibid., p. 110.

not certain whether all except 7 of the reserves would not be as appropriate if the subsidiaries were domestic rather than foreign.

On the basis of the evidence presented above, there is some justification for questioning the reasonableness of the fear of losses associated with foreign operations.

Conclusion

The three professional organizations are in general agreement that under certain circumstances it is advisable not to include the accounts of foreign subsidiaries in consolidated financial statements. They are also somewhat vague about the exact nature of the obstacles to their consolidation. In those instances when the definition of the obstacle is rather explicit, the evidence thus far presented appears to warrant hesitation in the acceptance of its validity. The resulting alternative methods of presentation of the financial data of foreign subsidiaries recommended by the American Institute of Certified Public Accountants in particular, permits wide variations in policy under the same set of conditions depending upon the interpretation of the evidence accepted. The contention that even less uniformity exists in the policies guiding the preparation of consolidated statements including foreign subsidiaries than did in situations where only domestic subsidiaries were owned appears to have been borne out by the illustrations and examples presented. It is hoped that the subsequent inquiry into the theory of consolidations will be beneficial in the attempt to reconcile some of the contradictions thus far encountered.

CHAPTER IV

THEORY OF THE BUSINESS ENTITY

Introduction

The introductory remarks made at this point are applicable to the current chapter and the next five chapters of the report. In this part of the thesis primary attention is devoted to theoretical considerations.

The second chapter revealed the two major requirements for the consolidation of the accounts of an affiliated company with another company. They were a majority ownership of the voting shares of the subsidiary by its parent and homogeneity of the operations of the two corporations. The possibility of exceptions to the majority ownership rule was recognized. They usually took the form of obstacles to the consolidating process in situations where majority ownership was present. Homogeneity as a requirement for consolidation was also questioned. It was perhaps less severely criticized than the majority ownership rule.

Chapter III revealed an additional deterrent to the consolidation of foreign subsidiaries. It was the fear of restrictions on the transmission of funds from the overseas operation to its domestic parent.

The validity of these three prerequisites is investigated in the remaining pages of this paper. To do this a theoretical framework is constructed. Its foundation consists of a chapter devoted to an examination of the role of the business entity in our society and the concepts of the corporate form of organization which seem to have received general acceptance.

In the succeeding chapter the entire structure of corporate combinations is examined with the objective of determining whether it is possible to apply the same concepts used to describe a single business entity to a group of entities. Finally, one form of business combination is considered, that of the consolidated enterprise. Again, consistency of reasoning is the objective. It is hoped that the conclusions reached regarding the soundness of the aforementioned criteria for consolidations will thereby be based upon sound theoretical grounds and will also prove to be of practical value.

Since the foreign subsidiary is assumed to have the same status as its domestic counterpart except for its location outside the national boundaries of the country of its parent, the problems associated with this characteristic are examined in a separate chapter. It should be emphasized that it would be fruitless to consider the foreign subsidiary as an isolated phenomenon. It is necessary to deal with the general theory of consolidations before it is possible to apply it to a special case. Hence, the subject matter of the entire dissertation may properly be conceived as pertaining to the role of the foreign subsidiary corporation in the consolidated enterprise.

The Concept of the Business Entity

In our complex industrial society a large part of the economic activity takes place through the medium of entities which serve the society as organizing units for the production of goods and services.

Postulate A-3. Entities (including identification of the entity). Economic activity is carried on through specific units or entities. Any report on the activity must identify clearly the particular unit or entity involved.¹

The postulate stresses proper identification of the entity. This is of paramount importance if there is to be any validity to conclusions reached about the efficiency of the entity in performing the administrative tasks assigned to it. The reports describing the activities of the entity are the means of communication between it and those whom it serves. These reports evolve from the accounting process. It has been said that the primary function of accounting is to accumulate and communicate information essential to an understanding of the activities of an enterprise, whether large or small, corporate or non-corporate, profit or non-profit, public or private.²

It has been contended that accounting is institutional.³ The term "institution" embraces all three major forms of business organization; the proprietorship, partnership and corporation. It applies regardless of the size of the unit and is characterized by the existence of a

¹Maurice Moonitz, op. cit., p. 52.

²Committee on Concepts and Standards Underlying Corporate Financial Statements--American Accounting Association, "Accounting and Reporting Standards for Corporate Financial Statements 1957 Revision," Accounting Review, (October, 1957), p. 536.

³W. A. Paton and A.C. Littleton, An Introduction to Corporate Accounting Standards, Monograph No. 3. (Ann Arbor: American Accounting Association, 1957), p. 8.

single management.¹ The term is used herein to refer to the corporate form of organization and combinations of that form.

The financial reports used to describe the activities of an institution, or entity, are based on conventions derived from experience.² These conventions represent an attempt by the accountant to satisfy recognized needs in the most useful manner. There are a number of concepts underlying the conventions of accounting.

To warrant general acceptance, a concept should prove to be useful. From it, it should be possible to derive principles. The principles may then be used as the basis for practical application of the theory. If practice is not consistent with the theory the validity of one or the other or both is open to question.

Fairness in the presentation of the results of operations and the position of the entity is another concept accepted by the accounting profession. Its importance is emphasized by an authority.

There is a very large community of interest behind every important income statement. In a very real sense the modern large corporation is an unusually efficient cooperative society whose creative activities spread large benefits widely. The community thus associated in laying claim to a sharing of the revenue produced includes: consumers, who use the products; workers, who create and distribute the products; management, which

¹Ibid.

²"Accounting and Reporting Standards for Corporate Financial Statements 1957 Revision," op. cit., p. 537.

supervises and plans productive activities; investors, who supply the savings needed to create production facilities and to pay many claimants in advance of the receipt of proceeds from sales; government, which needs tax revenue from enterprise income in quantities varying according to the scale of activities laid upon governmental agencies.¹

A leading firm of Certified Public Accountants supplements the statements of Mr. Littleton when it observes that

The Public. The interest of the public involves primarily the question of whether the financial facts have been properly presented on a basis that is fair to the other five segments previously discussed. The government through regulatory agencies represents the public in a broad sense.²

It is apparent that both quotations stress the interest of the public in a fair presentation of its financial facts by the corporation. This would seem to be a necessary adjunct to the consistency between theory and practice advocated earlier.

It is unfortunate that although the concept of fairness has been advocated repeatedly by prominent members of the profession, no widely accepted definition of the term has appeared.³ Definition does not appear to be within the province of this thesis. Use of the word is justified on the grounds of general acceptance. Usage without precision of meaning is a fault shared by many words employed in the language of the profession.

¹A. C. Littleton, Structure of Accounting Theory, Monograph No. 5, (American Accounting Association, 1953), p. 33.

²Arthur Andersen & Co., The Postulate of Accounting (September, 1960), p. 39.

³Maurice Moonitz, op. cit., "Comments of Leonard Spacek," p. 57.

Concepts of the Corporate Organization

Four Basic Concepts.--There are many concepts which attempt to describe the basic nature of the corporate form of business organization. Several of these ideas are of particular importance to the accounting profession. They are listed below.

1. The concept of the corporation as an association of common shareholders who are the owners of the corporate assets and obligors of the corporate debts.

2. The concept of the corporation as a separate and distinct entity existing and operating for the benefit of all long-term equity holders.

3. The concept of the corporation as a social institution.

4. The term "corporation" as merely indicating a prescribed set of legal relations.¹

The fourth concept emphasizes the legal effects of transactions rather than the economic effects which are stressed by the other three concepts. It does so on the presumption that many accounting practices have their origin in various legal documents, among them corporate statutes and the Internal Revenue Code. This paper will not discuss the concept in detail on the grounds of limited acceptance by accountants.

The Entity Concept.--The primary source of this concept is the legal profession. A well-known quotation illustrates the connection.

¹Robert T. Sprouse, "The Significance of the Concept of the Corporation in Accounting Analysis," The Accounting Review (July, 1957), pp. 370-371.

Almost one hundred and fifty years ago, Chief Justice Marshall of the United States Supreme Court defined a corporation as "an artificial being, invisible, intangible, and existing only in the contemplation of law."¹

This definition implies that the corporate form of business organization enjoys only those privileges which the charter of its creation confers upon it. Additional characteristics are described in a monograph.

The business undertaking is generally conceived of as an entity or institution in its own right, separate and distinct from the parties who furnish the funds, and it has become almost axiomatic that the business accounts and statements are those of the entity rather than those of the proprietor, partners, investors, or other parties or groups concerned.²

Accordingly, the statements of the corporation represent an accounting by it to all parties possessing claims against the entity. No significant distinction is necessary between common shareholders, preferred shareholders, bondholders and other long-term obligees. Moreover, the corporate assets are considered to be owned by the corporation.

Accounting Principles Under the Entity Concept.--Among the principles derived from any accounting theory it seems reasonable to expect reference to certain major items. For example, the disposition of interest, taxes, profit sharing distributions, earnings and retained earnings should be consistent with the theory.

¹William W. Pyle and John Arch White, Fundamental Accounting Principles, (Homewood, Illinois: Richard D. Irwin, Inc., 1963) p. 464.

²W. A. Paton and A. C. Littleton, op. cit., p. 8.

The American Accounting Association suggests the following treatment for certain of these items.

Interest charges, income taxes, and true profit-sharing distributions are not determinants of enterprise net income.¹

There are disagreements with this approach among accountants. One variation to the suggestions of the Association is the deduction of the items mentioned as expenses in the computation of net income. The line of reasoning advanced in an article is as follows.² Cash dividends are comparable to insurance costs. Insurance costs are properly deductible as an expense because they are incurred to promote a corporate objective. They are not unlike advertising expenses in this regard. Advertising promotes a merchandising atmosphere which solicits customers. Dividends promote a favorable investment atmosphere which solicits investors. They insure continued marketability of corporate securities and are therefore quite similar to insurance costs.

Much of the debate about the entity point of view as applied to corporations centers about the nature of income, retained earnings and dividends. According to another writer the entity point of view should

¹Committee on Concepts and Standards Underlying Corporate Financial Statements--The American Accounting Association, op. cit., p. 540.

²David H. Li, "The Nature and Treatment of Dividends Under the Entity Concept," The Accounting Review, (October, 1960), p. 675.

result in the following line of reasoning.

1. Income earned by the corporation is entity income and not the income of the stockholder participants.
2. Any resulting retained earnings constitute part of the corporate entity's equity in itself.
3. A distribution of assets which reduces the corporate entity's equity in itself (a cash dividend) or the transferring of part of the corporate entity's equity in itself to the stockholders (a stock dividend) transfers to the stockholders something which was not theirs previously and therefore constitutes income to the stockholders.¹

The American Institute of Certified Public Accountants apparently agrees with the opinion expressed in point one.

In applying the principles of income determination to the accounts of a shareholder of a corporation, it is generally agreed that the problem of determining his income is distinct from the problem of income determination by the corporation itself. The income of the corporation is determined as that of a separate entity without regard to the equity of the respective shareholders in such income.²

Messrs. Paton and Littleton seem to share this point of view.

If the corporation were viewed as merely an aggregation of individual investors, it would be consistent to hold that the earnings of the enterprise belonged to the

¹George R. Husband, "The Entity Concept in Accounting," The Accounting Review, (October, 1954), p. 555.

²Committee on Accounting Procedure, Accounting Research Bulletin No. 43, op. cit., p. 50.

investors from the moment of original realization. Emphasis on the entity point of view, on the other hand, requires the treatment of business earnings as the income of the enterprise itself until such time as transfer to the individual participants has been effected by dividend declaration.¹

In regard to point two the Institute expresses its opinion in the following manner:

Under conventional accounting concepts, the shareholder has no income solely as a result of the fact that the corporation has income; the increase in his equity through undistributed earnings is no more than potential income to him.²

The same source asserts that a distribution, division or severance of corporate assets is necessary in order for the shareholder to have income.

Criticism of the Entity Theory. -- Messrs. Paton and Littleton have this to say about the interim status of corporate income.

Between the moment when profit has been earned by the enterprise and the moment when profit-assets are distributed to investors, those who contributed capital have a claim against the assets according to their contracts.³

There is the paradox of including earned surplus as a part of stockholders equity in the balance sheet, however. An attempt is made to explain this practice.

¹Paton and Littleton, op. cit., p. 8.

²Committee on Accounting Procedure, Accounting Research Bulletin No. 43., op. cit., p. 50

³Paton and Littleton, op. cit., p. 8

The origin of earned surplus is essentially the accumulated balance of the income account. Once the transfer to surplus has been effected, however, the income balance becomes an acknowledged element of stockholders' equity. . . . In measuring the equitable share of the stockholders, in other words, surplus must be combined with the amount invested.¹

Another writer criticizes the contradiction in these statements.

Presumably some sort of transformation takes place between income and retained earnings which converts the former from its legal entity status to agency status in the case of the latter.

From one point of view, since Paton and Littleton hold that profits and losses are changes in assets to hold that the increased stockholders' claim is not profit is merely to hold that debits are not credits, or that assets are not equities, and has no more significance than just that.²

In addition, if the retained earnings do not belong to the stockholders there is little justification for the computation of book value, since this figure includes retained earnings. It is obvious that retained earnings cannot be both a part of the corporate entity's equity in itself and a part of the stockholders' equity. The confusion increases if a dividend is paid in stock rather than in cash.

In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets.

¹Ibid., p. 105.

²George R. Husband, op. cit., pp. 554-555.

However, it cannot fail to be recognized that merely as a consequence of the expressed purpose of the transaction and its characterization as a dividend in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received.

The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued.¹

Again, there may be disagreement in regard to the account charged and the amount. One writer suggests a charge to paid-in surplus with an amount left to the discretion of the corporation.²

The inconsistencies of the Institute's position are succinctly stated in an article in which it was pointed out that if there is no income earned by the stockholder without a distribution, division or severance of corporate assets; to treat a stock dividend as if it were a dividend resulting in income merely because the shareholder wrongly thinks it is income is in error.³

In summary, a cash dividend is a distribution of income according to the entity theory. According to the same theory a stock dividend cannot

¹American Institute of Accountants, op. cit., pp. 50-52.

²Li, op. cit., p. 678.

³Charles T. Horngren, "Stock Dividends and the Entity Theory," The Accounting Review, (July, 1957), p. 383.

be so considered because there is no severance of corporate assets accompanying the payment of the dividend. However, if earned surplus is reduced as a result of the declaration of the dividend it may be contended that there is a transfer of corporate equity to the shareholders regardless of whether the credit is to a liability account (and eventually to an asset account) or to a capital account. If there is a transfer of corporate equity to the stockholder the argument is that he must have received income because he now has a claim against the corporation which did not previously exist.

The contradictions that have been referred to usually arise as a result of transactions between the business and its owners. For example, the compensation of a partner ordinarily is not considered to be an expense of the partnership, whereas the salary paid to a stockholder-employee is deducted as an expense of the corporation. It is appropriate to consider whether in the interest of consistency the same concepts of such basic items as assets, liabilities, capital, income, expense and profit and loss are to be applied to all forms of business organizations in spite of possible contrary legal authority.

The Proprietary Concept.--The proponents of the proprietary theory of the corporation contend that the corporate entity is a fiction and that it cannot initiate or direct action. They aver that this fiction was first perpetrated for the benefit of the common shareholders. They admit that it also facilitates the process of regulation and taxation and therefore contributes to the protection of the public but they also believe that they are not deceived by these characteristics.

For purposes of economics and accounting, the corporation might well be viewed as a group of individuals associated for the purpose of business enterprise, so organized that its affairs are conducted through representatives.¹

The primary objective of those who accept the proprietary theory seems to be consistency in the theoretical approach to the accounting problems of all business organizations.

The basic purpose of the corporate business organization does not differ from the basic purpose motivating the organization and operation of business sole proprietorships and partnerships: In each case the individuals providing the basic investment funds seek to obtain profit through the medium of rendering social services.²

To the writer quoted above the core principals in free enterprise activity are the individual entrepreneurs who use the various forms of business organization for personal ends.³ He rejects the entity theory.

Whenever fiction and reality come to grips, as they do when the corporation is involved in transactions with its own shareholders, the gap between the two may be solved in only one of two ways: (1) by piercing the veil of fiction; or (2) by continuing to treat the problem in a manner consistent with the assumed fiction. In the latter case it should be recognized that the solution itself is a fiction and adjustment made therefore in all cases in which it appears to be necessary.⁴

It is apparent that Mr. Husband prefers to solve the problem by "piercing the veil of fiction." He has said that accounting comes closest

¹George R. Husband, "The Corporate-Entity Fiction and Accounting Theory," The Accounting Review, (September, 1938), p. 243.

²George R. Husband, "The Entity Concept in Accounting," op.cit, p.553.

³Ibid.

⁴Husband, Ibid., pp. 557-58.

to reality and to being of economic service when it recognizes this fact, when it measures "entrepreneurial" success or failure, and when it imputes profit or loss to the "entrepreneurial" actors.¹ To him it is obvious that the legal concept of the entity does not coincide with its accounting concept. "For accounting purposes it is the entity of experience which is of importance."² As a consequence the proprietorship, the partnership, the corporation, the parent and subsidiary corporations, each constitutes an experience entity which must be accounted for. In reference to the preparation of consolidated statements the same author comments as follows.

In fact, in the case of parent and subsidiary companies the lines of legal entity contribute to accounting problems and confusion; clearer vision of the experience entity is obtained by ignoring the divisional lines which the laws establish.³

Accounting Principles Under the Proprietary Concept.--The American Accounting Association suggests the following approach under the proprietary concept.

In determining net income to shareholders, however, interest charges, income taxes, profit sharing distributions, . . . are properly included.⁴

Income earned by the corporation is the income of the stockholder participants. Retained earnings are part of the stockholders' equity and there is no question of their position on the balance sheet. The calculation

¹Ibid., p. 558.

²Ibid., p. 552.

³Ibid.

⁴Committee on Concepts and Standards Underlying Corporate Financial Statements--The American Accounting Association, op. cit., p. 540.

of book value is not subjected to criticism. In the event of a stock dividend the transfer from retained earnings to capital stock is legitimate.

Legal Basis for the Entity Concept.--Since the entity theory is based upon legal premises it is appropriate to examine their validity. Mr. Husband refers to those instances when the law and the courts, in their attempt to control the development of trusts, have found it necessary to go behind the corporation fiction and prescribe penalties for corporate officers as well as for the corporation.¹ Mr. Paton corroborates the views taken by Mr. Husband and also refers to the inconsistencies of the legal profession in these matters.

On the other hand, there is a danger that this assumption may be carried too far. The fact of the independent existence of the business entity must not be overstressed. No institution, however real, has any absolute existence. The accountant must remember that human beings are the immediate means by which the affairs of a business institution are conducted and that, in particular cases, it may be necessary to focus attention directly and exclusively upon the individual owners and managers for their acts. As was stated in Chapter XV, the courts have long recognized that the apparent act of the business must sometimes be construed to be the act of an individual owner, and that, in other cases, the apparent act of the individual must be virtually the act of the institution.²

If a single clearly defined legal concept of the business organization existed, there would be considerably greater justification for its adoption as a basis for accounting practice. In 1957 a comprehensive survey of the legal literature was conducted for the purpose of determining the

¹George R. Husband, "The Corporate-Entity Fiction and Accounting Theory," op. cit., p. 243.

²William A. Paton, Accounting Theory (Chicago: Accounting Studies Press, 1962), p. 476.

extent to which the legal profession accepted the entity concept of the corporation and the extent to which it advocated other concepts.¹ It was decided that "the acceptability of accounting analyses cannot with confidence be based entirely upon a particular legal concept of the corporation."² If the legal profession is unable to agree upon a particular concept of the corporation, it would seem unreasonable for the accounting profession to accept the alleged "legal" concept without reservation. Moreover, any attempt to apply this concept to other forms of business organization should be viewed with caution.

Appraisal of the Entity and Proprietary Concepts. -- It has been said that the two theories differ primarily in respect to (1) the nature of the business enterprise, (2) the viewpoint to be taken of the fundamental accounting structure, and (3) relative emphasis to be placed on legal, economic, and accountancy concepts.³

Because they consciously or unconsciously usually select one of them in preference to the other in the process of resolving issues which arise in their practices, accountants should be particularly interested in the two theories and aware of their implications.

The two theories mentioned do not offer a common meeting ground, and if an accountant is not persistent in holding to one or the other, his conclusions as to matters of interest are likely to be inconsistent and unreconcilable.⁴

¹Robert T. Sprouse, "Legal Concepts of the Corporation," The Accounting Review (January, 1958), p. 37.

²Ibid.

³George Hillis Newlove and S. Paul Garner, Advanced Accounting, Vol. 1, (Boston: D. C. Heath and Company, 1951), p. 20.

⁴Ibid.

If he accepts the entity viewpoint as a basis for corporate accounting, the strict entity theorist must also select it for proprietorship and partnership accounting purposes, as well.

But since . . . the law does not confer full legal entityship for business purposes on all forms or organizations, there is a contradiction between the acceptance of the entity theory and the law.¹

Therefore, the entity theorist has the choice of not being consistent or ignoring the contradiction inherent in his acceptance of the theory. At the other extreme, the proprietary theorist must ignore the legal entity aspects of the corporation since they are contrary to his interpretation of the nature of the business enterprise.

As previously mentioned, it appears that legal considerations are at the root of the paradoxes described above. It also seems evident that legal entityship cannot be reconciled fully with either of the accounting theories under discussion.²

It is concluded that the proprietary view, which abandons the impersonal business entity as the focal point of the accounting process and looks upon the business organization as an agency serving the entrepreneurs, is the more acceptable of the two theories. It is not necessarily considered to be the best theory as evidenced by the following section.

From the discussion in the first section of this chapter it seems logical to conclude that the free enterprise system originates with natural persons and serves them. Among them are entrepreneurs. One of their functions is the allocation of resources and their goal is profit. In

¹Ibid., p. 22.

²Ibid., p. 22.

the corporate form of business organization, the common shareholders are the entrepreneurs. Hence, one of the more important objectives of the accounting process is the provision of information which is of benefit to the common shareholders in the direction of their activities.

The Corporation as a Social Institution.--The entity theory has to some extent diverted attention from a consideration of the broad social implications of accounting. Messrs. Newlove and Garner comment that "the latter have only begun to be investigated within the past few years, with the result that accounting is now being viewed by some individuals in a perspective almost entirely distinct from the traditional associations and responsibilities."¹ On page 52, Mr. Sprouse referred to the social institution concept of the corporation. His version of the concept views the corporation as being separate and distinct from the contributors of its capital, as does the entity theory.² But its financial reports are not directed to the investors. Instead they are prepared for the use of the public. This is because the unique feature of the concept is its assumption that the primary objective of the corporation is economic growth in the interest of society.³

Another writer believes that neither the proprietary nor the entity theory accurately describe the structure and behavior of the large corporation.

¹Newlove and Garner, op. cit., p. 3.

²Robert T. Sprouse, "The Significance of the Concept of the Corporation in Accounting Analysis," op. cit., p. 370.

³Ibid.

In both the proprietary and entity theories of the firm, the rationale for the reported income figure is the existence of a natural or artificial person with a claim to the income. The entity theory substitutes the personality of the entity for the personality of the proprietor and thus neatly solves the problem of perpetual succession.

When the entity theory refers to the large corporation as an "institution in its own right" it is certainly close to the mark. But the concept of the large corporation as an institution requires more than a mere statement to that effect; it requires, above all, an analysis of the meaning of the term and what the implications of the institutionalized corporation are for accounting theory.¹

The references made to the social institution theory of the corporation refer to the entity theory as a basis for the proposed new concept.

The Relationship Between the Entity and Social Institution Concepts.--

According to an eminent economist one result of the growth of a corporation is the separation of ownership from management.

A point arrives in the growth of a big institution. . . at which the owners of the capital, i.e., the shareholders, are almost entirely dissociated from the management, with the result that the direct personal interest of the latter in the making of great profit becomes quite secondary . . . The shareholders must be satisfied by conventionally adequate dividends, but once this is secured, the direct interest of the management often consists in avoiding criticism from the public and from the customers of the concern.²

There is the question of whether the owners are dissociated from the management or whether it only appears that they are and if they are whether there is any significant change in motive. It may also be asked

¹Waino O. Suojanen, "Accounting Theory and the Large Corporation," The Accounting Review (July, 1954), pp. 391-392.

²John Maynard Keynes, Essays in Persuasion (New York: Harcourt, Brace and Co., 1932), pp. 314-315.

if the wish to avoid criticism really does result in a reduction of the desire to maximize profits or simply in a less discernible remification of this objective. Finally, it seems fair to speculate about whether dividends occupy as important a position in the thoughts of the owners as they appear to occupy in those of Mr. Keynes.

Another economist comments about corporate control.

Furthermore, whatever control is exercised by owners frequently comes from specific groups rather than from the rank and file in general. In many corporations ownership is so thinly diffused that no ownership control can be exercised. . . .

In the great majority of the remaining corporations in which a group of significant stockholders does exist, this group is a minority group. In many of these corporations such minority control is quite effective, in others it may be loose and at best very general.

Some of the most significant enterprises of the country belong in the category of corporations with no "visible center of ownership control. . . ." ¹

Mr. Fellner goes on to cite examples of minority control, among them the DuPont family, which formerly controlled E. I. DuPont de Nemours & Co., the General Motors Corporation and the U.S. Rubber Company.² It is particularly significant that he is so acutely aware of the existence of minority control of major industrial organizations and/or groups of those organizations. It is unfortunate that he does not emphasize the fact that lack of a "visible" center of control does not mean that control does not exist. Moreover, the existence of widespread ownership of shares does not

¹William Fellner, Competition Among the Few (New York: Augustus M. Kelley, 1960), p. 169.

²Ibid., p. 169.

preclude the possibility of combination of certain shareholders into a group which can seize control. The present ineffectiveness of such control may exist only because the owners are satisfied and therefore have no reason to exert pressure on the management. Mr. Fellner seems at least partially to support these views with the following comments.

Case studies show that the influence of owner groups varies--from one enterprise to the other and also in the passage of time--with the personalities of which the groups consist and in some cases also with the phase of development through which the firms are going.¹

His statements on the possible divergence of the interests of owners and managers qualify his earlier comments and also refute to some extent the assertions of Mr. Keynes.

Even where ownership and control are divorced, the interests of honest management are not opposed to ownership interests in any crude sense of the word. To be sure the management is interested in earning high salaries which are a deduction from gross revenue in calculating profits. But this does not make the management less keen to maximize profits. Managerial money income usually moves up and down with profitability.²

Mr. Fellner refers to the effect public opinion has on the profit motive and on the nature of profits.

Reckless exploitation of monopolistic, monopsonistic, oligopolistic or oligopsonistic positions may result in regulation by public policy.

Therefore, instead of profit maximization we should say: "the maximization of the stock concept (present-value concept) corresponding to the relevant profit-flow expectations, corrected for expectations of capital

¹Ibid., p. 170.

²Ibid., pp. 171-172.

gains and losses, and interpreted not in terms of market valuation but on the basis of management's attitude to probable future market developments and on the basis of its assumption about future ownership and control of the enterprise itself.¹

Therefore, it may be that there is no diminution of the desire for profits but merely a change in the concept of what constitutes profits, as well as a substitution of a long-range viewpoint for the short-range viewpoint expressed by Mr. Keynes.

Even William J. Baumol in his "sales maximization hypothesis" assigns a very important place to profits and his concept of profit is somewhat in accord with the concept just described.

I am prepared to generalize from these observations and assert that the typical oligopolist's objectives can usefully be characterized, approximately, as sales maximization subject to minimum profit constraint.

We may then surmise that the minimum acceptable rate of profits is that which just satisfies stockholders when it is divided between dividends and re-investment in the manner which most closely accords with stockholder preferences.²

It seems reasonable to presume that the stockholder is still interested in maximizing his rate of return. This desire is satisfied partly by the payment of dividends and partly by the accretion in the value of his investment that occurs in the market. So long as both profits result in a rate of return that is satisfactory to him it is unlikely that he will interfere with the managers of the corporation. A satisfactory rate of

¹Ibid., p. 166.

²William J. Baumol, Business Behavior Value and Growth (New York: The MacMillan Company, 1959), pp. 49-52.

return is a subjective evaluation and need not be the maximum return available in some alternative form of investment. However, there probably are constraints which do establish a minimum rate of return in each case. In the recent past, earning a profit was no particular feat for most established corporations. Hence, the emphasis was on sales maximization. There was some expectation of accompanying profit increases by the corporation but the really important factors to the common shareholder were the amounts of the dividend payments and the increased capital gain that occurred as a result of the rise in the market price of his investment, which in turn was at least partly based on the present performance and anticipated future performance of the corporation whose stock he owned. The present performance was primarily measured by the increase in profits and the anticipated future performance by the increase in sales, both as compared to prior periods and as compared to those of rival corporations. These allegations were partly supported by Mr. Fellner and receive added support from Mr. Baumol.

There appears to be some evidence that, in practice, a greater proportion of earnings than desired by stockholders is usually retained by the firm. For the value of stocks is apparently more closely correlated with dividend payments than it is with retained earnings. This suggests that an increase in dividend payments at the expense of retained earnings can benefit stockholders doubly--by increasing the value of their stocks as well as their dividend payments.¹

In addition, there exists a very pragmatic reason for not maximizing profits of the individual firm in the short run.

¹Ibid., p. 52.

(a) Long-run consequences of violating accepted value judgments (that is, of faring too well): In any going society, certain ideas of right and wrong limit the extent to which a person or an institution may benefit at the expense of others without being regarded as "taking advantage" of them. In the long run, it is unwise to "take advantage" of others, because this is apt to result in organized social action on behalf of the victims. . . . The social esteem of long-established institutions rests largely on the feeling that it is impossible to survive long without observing certain limits set by quasi-ethical considerations.¹

To contend that the monopolistic or oligopolistic group does not maximize profits in the long run in the manner suggested seems to be unreasonable in the light of the evidence presented to the contrary. It seems equally unlikely that the stockholders do not assert their right to control when circumstances so dictate. Control may be exercised by a minority group.

Conclusions

At this juncture it seems reasonable to assert that decisions made in the corporation affect not only the owners but also employees, creditors, customers, governmental agencies and the public. That the profession is concerned about the problem of accounting to them is evident from this comment.

In my opinion our greatest deficiencies exist in the regular annual reports to stockholders. These reports, whether we want to believe it or not, are not just reports to stockholders--they are also annual reports to the public, to labor, and to the consumer.²

¹Fellner, op. cit., pp. 24-25.

²Leonard Spacek, "The Need for an Accounting Court," The Accounting Review (July, 1958), p. 370.

This problem is not new, as evidenced by the following comments written more than twenty years ago.

When the accountant once was concerned merely with assisting the owners of a business to evaluate its operations in money terms, he now must recognize a broad social responsibility. His findings, and the manner in which he sets them forth, have become the basis for significant decisions and policies, not only in business affairs, but in economic, social, and political matters as well.¹

The findings of the accountant are significant because of the type of society within which he functions. When people cooperate in producing units with the objective of satisfying human wants their actions and the actions of the corporations they serve affect the welfare of others.

Consequently, it would seem that the role of a "self-contained abstraction"² which the entity concept assigns to the corporation is not broad enough because it fails to emphasize the role of the firm in society. The society creates its institutions with the objective of serving its purposes. If the institution does not perform its task as well as another institution might, its continued existence will not be permitted by the public. Hence, the concept of the corporation should reflect this responsibility to society.

There are other reasons why the entity concept does not seem to be suitable. The entity concept has its foundation in legal technicalities rather than in economic principles. This is reason enough to question its validity; but if it were not, the very fact that there is little consistency in the legal technicalities themselves should create doubt about the

¹W. A. Paton and A. C. Littleton, op. cit., p. V.

²Suojanen, op. cit., p. 393.

sufficiency of the concept. The veil of separate corporate existence, in the writer's opinion, has been pierced frequently enough, to use Husband's terminology, to question its usefulness for accounting purposes.

From a technical point of view, the use of the entity concept results in inconsistencies of treatment of certain items that are serious enough to warrant consideration of its abandonment, as pointed out by Mr. Husband. While consistency is not a virtue in itself, if it can be attained without sacrificing other more worthwhile goals it is certainly to be desired.

Finally, the entity concept attempts to divorce the corporation from its owners. Because the owners use what may be called the "exception" principle in the assertion of their authority does not mean that the authority does not exist. It is hypothesized that there is no real separation of the entrepreneurs from the organization, only an apparent separation that is a product of the time in which we live. Ownership may not always be readily apparent but in the final analysis it does exist, with all its privileges as well as its responsibilities.

Therefore, the contention is that the owners are the instruments of society in the direction of one of its institutions, the corporation. The social institution concept of the business enterprise is accepted; but with the proprietary concept, rather than the entity concept, as its base. Hence, reports about enterprise activities should be directed to the owners but prepared for the use of the public. The form and content of

financial statements are envisioned to be the responsibility of the professional men to whom society designates this function. It would seem that the logical choice for this role is the certified public accountant. If the public accepts the judgments of physicians and lawyers in their areas of competence, it seems reasonable to expect it to trust the certified public accountant in his area.

The author agrees with Mr. Adolph A. Berle, Jr., who has said, "The corporation is emerging as an enterprise bounded by economics, rather than as an artificial mystic personality bounded by forms of words in a charter, minute books, and books of account. The change seems to be for the better,"¹ and with Myron J. Gordon, who commented, "Income is a sociological phenomenon and the validity of a set of rules for measuring an entity's income must be found in the sociology of the entity."²

¹Adolph A. Berle, Jr., "The Theory of Enterprise Entity," Columbia Law Review (April, 1947), p. 345.

²Myron J. Gordon, "Scope and Method of Theory and Research in the Measurement of Income and Wealth," The Accounting Review (October, 1960), p. 610.

CHAPTER V

BUSINESS COMBINATIONS

Introduction

The phrase "conventionally adequate dividends" has been used earlier in this report and their purpose has been described. Subsequent to the payment of dividends there are surplus funds available which can be used for various purposes. One author links these excess funds to the increasing trends toward research and product diversification and contends that new products must be developed to insure full utilization of the capacity to produce.¹ The excess funds are also related to the postwar merger movement through the growth and survival motives, according to the same source.²

In a much quoted article it has been stated that the rate of mergers of important United States industrial corporations was about forty-five per month. The article goes on to say that practically every corporation in the United States whose net worth was \$1 million or more had been involved in at least preliminary merger negotiations.³ From 1945 until the date of the article there were at least 7500 important mergers.⁴ Four reasons were given for the trend and the author states that "unless there

¹Waino O. Suojanen, "Enterprise Theory and Corporate Balance Sheets," The Accounting Review (January, 1958), p. 64.

²Ibid.

³William B. Harris, "The Urge to Merge," Fortune (November, 1954), p. 102.

⁴Ibid., p. 103.

are basic changes in the economy, the trend will go on at about the present rate.¹ The reasons presented were growth, market considerations, taxes and survival motives.²

Types of Mergers

There are three major types of mergers.

Merger can be horizontal (broadening a company's base in similar markets), vertical (moving forward to the consumer level or back to raw materials in an industry), or conglomerate (banding together companies in dissimilar industries).³

One type of merger is further described.

The conglomerate merger, made by joining companies engaged in dissimilar businesses into a combination operating-holding company, and maintaining them as separate divisions, is a new merger force.⁴

Actually, the term "merger" as used herein includes two types of business combinations.

The bringing together of two or more business entities, usually corporations, into one, accomplished by transferring the net assets of one or more entities to another of them (a merger) or to a new one created for that purpose (a consolidation). Either action may, in effect, be a purchase, with one or more groups of stock holders retiring, or a pooling of interests may occur in which the stockholders of all the participants share.⁵

¹Ibid.

²Ibid., pp. 103-236.

³Ibid., p. 103.

⁴Ibid., p. 104.

⁵Eric L. Kohler, A Dictionary for Accountants--2d ed. (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1957), p. 77.

At the present time the business combination movement is a topic for study by a committee of the American Institute of Certified Public Accountants.¹

Recently there has been a considerable amount of discussion of the pooling of interests form of merger or consolidation. The American Institute provides a good description of this method of combination.

In contrast a pooling of interests may be described for accounting purposes as a business combination of two or more corporations in which the holders of substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors discussed below are present. . . .

However, the continuance in existence of one or more of the constituent corporations in a subsidiary relationship to another of the constituents or to a new corporation does not prevent the combination from being a pooling of interests if no significant minority interest remains outstanding, and if there are important tax, legal or economic reasons for maintaining the subsidiary relationship. . . .²

The Bulletin is careful to point out that the existence of a parent-subsidiary relationship need not do harm to the concept of a pooling of interests. The contents of Bulletin 48 are compared with those of Bulletin 40.

¹Currently being prepared by Arthur Wyatt under the direction of the Project Advisory Committee and the Director of Accounting Research, CPA (February, 1962), p. 3.

²Committee on Accounting Procedure -- American Institute of Accountants, Accounting Research Bulletin No. 48 -- Business Combinations (January, 1957), p. 22.

Four tests emerged. A continuity of substantially the same proportionate equity interests, relative size, continuity of management, and similar or complementary activities. As the trend toward diversification developed, this last test declined in importance and was not repeated in the new Bulletin No. 48 published in January 1957.¹

Mr. Suojanen has referred to the trend toward product diversification in the individual corporation and a review of the growth motives for merger as presented by Mr. Harris must result in the conclusion that diversification is the inevitable result of many, if not most, mergers and may even be a reason for merging. Therefore, the decline in the importance of "similar or supplementary activities" as a test to determine the existence of a pooling of interests appears to be logical.

Merger and Parent-Subsidiary Associations

The mechanics of creating a business combination are described in the following quotation.

There are two principal forms in which the combining of previously separate, and perhaps competing, concerns have been brought about. In one, those interested in effecting the combination buy from one or more concerns their plants and other assets just as any purchaser may at any time buy a single article of merchandise.

In the other method the assets of the existing concern are not bought The transaction is one between the combining corporation, ordinarily called the holding company, and the individual stockholders of previously existing corporations. . . . The former stockholder sells his shares and the purchaser makes payment therefor in such medium as is mutually satisfactory.²

¹Andrew Barr, "Accounting Aspects of Business Combinations," The Accounting Review (April, 1959), p. 178.

²Henry Rand Hatfield, Accounting, Its Principles and Problems (New York: D. Appleton and Company, 1929), pp. 439-440.

Mr. Hatfield does not discriminate between the two methods in regard to final result. From his comments it may be concluded that there is little, if any, economic difference between a parent-subsidary relationship and any other kind of business combination.

This opinion is corroborated by the following comments.

The business combination movement in this country, however, has already produced the parent-subsidary relationship in which two (or more) legal entities are involved, but in which the appropriate accounting entity is the group as a unitary whole, treated as if it were. . . . a single company with one or more branches or divisions) (Accounting Research Bulletin No. 51).¹

While being careful to stress the differences between a parent-subsidary relationship and a true consolidation, another source comments that the same economic results may obtain from either.

In the parent-subsidary situation, the assets of subsidiaries are not transferred to the parent, nor do subsidiary corporations cease to exist. Under a consolidation, the assets of several corporations are transferred to a surviving corporation. In spite of those contrasting features, many of the same economic and business results are available from either alternatives.²

In discussing the basis for evaluation of investment, another article comments, "The authors see no distinction between a purchase of net assets and a purchase of capital stock and hope the occasional practice of using a basis for the net assets acquired that is in excess of the price paid

¹"Major Problem Areas in Business Combinations Study Summarized for Membership Comment." CPA (February, 1962), p. 3.

²Herbert E. Miller, (ed.), C.P.A. Review Manual (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1956), p. 375.

will soon be discontinued."¹

The exact nature of the economic or accounting entity which emerges from a pooling of interests is under debate just as it is in the case of the parent-subsidiary relationship. The debate is summarized in a recent article, wherein the author contrasted the viewpoints of Mr. George S. May and the Committee on Accounting Procedure contending that Mr. May assumes that the business which "emerges" from a combination of predecessor business is a new accounting unit and that the Committee believes that the constituent companies are simply divisions of an old accounting unit.² Thus, the committee's concept of a "pooling of interests" is the integration in one set of accounts of the accumulated transactions that were formerly contained in two sets. In other words, the emerging entity, if there is one, already has a financial history.

According to Mr. May, "The really important question is what monetary ascriptions should be given to capital assets on the books of the emerging corporations."³ Still, the identification of the entity is of prime importance for it has a profound effect on the accounting procedures which are put into practice.

Much of the confusion about the exact nature of the entity emerging from a business combination is the result of legal considerations, in this instance the Internal Revenue Code.

¹Norman J. Lenhart and Philip L. Defliese, Montgomery's Auditing, 8th ed. (New York: The Ronald Press Company, 1957), p. 479.

²William J. Schrader, "Business Combinations," The Accounting Review (January, 1958), pp. 72-73.

³George O. May, "Business Combinations: An Alternate View," The Journal of Accountancy (April, 1957), p. 34.

If handled as an acquisition, much larger depreciation or amortization charges against income would be necessary, although not necessarily tax deductible. When managements find that these increased charges are not tax deductible, they inevitably find ways and means of having the combination become a pooling of interests.¹

The objective of the foregoing discussion has been the construction of a frame of reference which permits the conclusion that all business combinations have certain basically similar characteristics. This is the contention of Messrs. Moonitz and Staehling, who group business combinations into two broad classifications, those that involve a parent-subsidary relationship and those that do not.² The second category consists of the mergers and consolidations. The prime characteristic of the merger is the retention of its identity by one of the merging corporations, whereas the consolidation results in the creation of a completely new legal entity. The mechanics of acquisition are described as a purchase of assets for cash or for the shares of the surviving or resulting corporation. When shares are the purchasing medium a pooling of interests may take place.

In the parent-subsidary relationship there is no loss of corporate identity. The parent may purchase shares of the subsidiary with cash or other assets, or with its own shares. In either case the subsidiary corporation itself is not involved, although its stockholders are of necessity

¹Phillip L. West, "The Reporting of Earnings to Stockholders," The Journal of Accountancy (February, 1959), p. 30.

²Maurice Moonitz and Charles C. Staehling, Accounting: An Analysis of Its Problems, Vol. II (Brooklyn: The Foundation Press, Inc., 1952), PP. 322-326.

parties to the transaction. Classification, of itself, is not important but the conclusions which may be drawn from it are.

Conclusions

It has been said that the conclusions developed in the business combinations research study have important corollary implications.¹ The author submits the contention that one of the most important corollary implications centers about the validity of homogeneous and/or integrated operations of sub-units as a criterion for the identification of the economic or accounting unit. It has been contended that as the corporation grows it becomes "less and less committed to a specific product line."² No source known to him has expressed dismay over preparing financial statements for a corporation which has diversified its operations, without resorting to merger or consolidation. There has been a similar lack of compunction over preparing statements for the new identity in situations where merger or consolidation has occurred. The importance of diversification in these situations was mentioned earlier in this section. Of course, various types of financial and operating reports may be and are prepared for the sub-units but this does not obliterate the fact that the income statement and balance sheet are prepared for the corporation as a whole. It is admitted that this may result in lack of comparability, but it is doubtful if comparability is possible under these circumstances.

¹"Comments, Suggestions Invited from Members on Intercompany Investment Research Study," op. cit., p. 3.

²A.D.H. Kaplan, Big Enterprise in a Competitive System (Washington, D.C.: The Brookings Institution, 1954), p. 194.

It has been contended that there is little, if any, difference between the parent-subsidary relationship and the entity that results from business combinations of the sort described in this section. There remains the question of whether it is possible to use the criteria referred to in the identification of an economic unit resulting from the parent-subsidary relationship when it is apparently of little use in circumscribing the limits of the merger or the consolidation, whether created by a purchase or a pooling of interests.

CHAPTER VI

CONSOLIDATED STATEMENTS

Introduction

Before discussing consolidated statements in detail, it may be worthwhile to consider the purpose they serve. It is almost universally agreed that both management and the certified public accountant are responsible for the disclosure of all material facts relating to the position and results of operations of the business entity. The preparation of consolidated statements should be considered with this viewpoint in mind. In reference to the usefulness and limitations of statements of the individual components of an economic entity, it has been said that while such statements provide the data in accordance with legal concepts thus minimizing the possibilities of inadequate disclosure for the individual corporation, they leave the work of summarization and diagnosis to the investor.¹

The Usefulness of Consolidated Statements

The author of a major work in the area of consolidations has said that investment in a dominant company is an investment in the entire affiliated group.² Mr. Moonitz was well aware of the limitations of consolidated statements.

¹Victor H. Stempf, "Consolidated Financial Statements," Journal of Accountancy (November, 1936), p. 358.

²Maurice Moonitz, The Entity Theory of Consolidated Statements (Brooklyn: The Foundation Press, Inc., 1951), p. 14.

They may not legitimately be offered as all-purpose reports capable of informing every group with an interest in some special phase of consolidated operations; they may be offered to and used by those groups with an interest in the whole area of combined activity.¹

Stating that the individual affiliated corporations are legally superior for purposes such as dividends and liability for debts, Mr. Moonitz concludes that consolidated statements do not replace, but supplement, the legal statements of constituent units.²

Another writer comments on the significance of consolidated statements.

The information presented by consolidated statements is almost exclusively significant to the long-term investors in and management of the parent corporation, and even in this connection there exists the possibility of inaccurate and misleading conclusions being drawn from consolidated reports. The minority stockholders and creditors of subsidiary corporations, as well as short-term creditors of the parent corporation, are concerned with the financial data of the specific corporate entity in which they have an equity, consolidated statements being of little significance. Long-term creditors of the parent corporation may gain some insight into future trends relating to the financial status of their debtor, but only of an extremely general nature.³

In rebuttal of the above quoted comments, it should be pointed out that the preparation of consolidated statements does not rule out the preparation of financial reports for the individual corporations comprising

¹Ibid., p. 83.

²Ibid.

³Samuel R. Hepworth, Reporting Foreign Operations (Ann Arbor: Michigan Business Studies, 1954), p. 158.

the consolidated entity. Moreover, there remains the question of the order of importance to be assigned interested parties. It seems that the stockholders of a parent company, particularly its controlling stockholders, deserve the type of statements that are most useful to them and consolidated statements may be the only presentations which are capable of fulfilling their requirements. Finally, the public interest is paramount under the enterprise theory, and it can be properly served only by consolidated statements.

The comments about the limited usefulness of consolidated statements were more pertinent in the past than they are in the present. The fact that there are changes occurring in the environment in which we live has already been established. It is undoubtedly true that they will continue since this is an atmosphere of a businessman's culture into which all of us are born and which governs most of what we do.

One aspect of the changing nature of the economy is the continuing broadening of share ownership and a resulting relatively small investment by the many. The former vice president of the New York Stock Exchange recognized the significance of this trend and the importance of providing the "many" with reports which they can understand.¹ A practicing certified public accountant has expressed his concern over meaningful, consistent reporting which the public is able to comprehend and recognized the responsibility of the profession to produce it.²

¹West, op. cit., p. 28.

²Spacek, op. cit., p. 370.

If investment in a parent company is indeed investment in an entire group of companies, and if business combinations are typical of the economic climate, it is becoming increasingly difficult to relegate consolidated statements to a minor role, particularly if the interests of society as a whole are of prime importance.

Legal Aspects of Consolidation

Mention has been made in Chapter IV and elsewhere of the influence of the legal profession in the formulation of the concept of the corporation. The importance of the legal entityship of the corporation has also been stressed in certain works on the subject of consolidations as revealed in the previous section of this chapter. The possible consequences of the legal attitude towards the preparation of consolidated statements appears to merit further investigation.

The position of the courts in regard to the acceptance of consolidated statements is stated in the following quotation.

Even in this country, paralleling an incomplete and inadequate comprehension of the essential economic unity of a combination through stock ownership, consolidated statements have not been generally accepted by the courts as replacements of "legal-entity" reports. Their status remains that of a supplement, a complement, an addition to but not a substitute for the statements of individual corporate units.¹

As a specific illustration, the ruling in the case of *Majestic v. Orpheum Circuit, Inc.* (21F2d 720) merits review. The court held that control of one corporation by another through stock ownership does not make the

¹Moonitz, op. cit., p. 10.

controlling corporation liable for the acts or obligations of the controlled corporation.¹ Still, while upholding the legal entity of the individual corporation, the same court admits the fiction of such entity and threatens to ignore it where "it is used as a blind or instrument to defeat public convenience, justify wrong, or perpetuate a fraud."² In such cases the courts will regard the corporation "as an association of persons."³ In an excellent article explaining the attitude of the legal profession in these matters, the following comments are made.

Thus it can be seen that, by and large, while the law courts today will accept a consolidated statement when directed to do so by a statute, they are often still loathe to lend it credence in many other situations. This is doubtless caused by the different approach of accounting and the law to the question of using consolidated statements. Whereas the accountant looks at the consolidated report as an impersonal source of facts of the condition and operations of the group from the sole standpoint of the parent company, the courts approach these statements as a source of evidence for the determination of the justice between several conflicting claims and interests--whether parent, subsidiary, majority or minority stockholders, or third parties, and will accept as a proper rule for a financial statement only that which will aid in the determination of that justice.

A second factor which has entered into the treatment by the courts of these statements has been the fact that in few situations the court approached the problem as purely an accounting one. Usually the case has involved mainly some entirely different difficulty between the parties to the litigation,

¹W. A. Paton, (ed.), Accountant's Handbook (New York: The Ronald Press Company, 1948), p. 1064.

²Ibid.

³Ibid.

and in deciding on that question, the court has incidentally and of necessity arrived at a conclusion which affects a principle of accounting.¹

In an editorial which appeared in The Journal of Accountancy, issue of October, 1942, the case of Cintas versus the American Car and Foundry Company was discussed. The comments of practicing certified public accountants called to testify on the subject of consolidations were noteworthy. Mr. Roy B. Kester submitted an affidavit in which he testified that the position and earnings of a corporation which owns all of the capital stock of a subsidiary corporation can be truly and accurately shown only in consolidated financial reports.² He continues by saying that any other statement of position or of earnings would not be certified by a reputable accounting firm without qualification.³ Another witness supplements the prior testimony by stating that in this situation the subsidiary was formed as a matter of convenience by the parent and, hence, this is a clear case for the application of the principles of consolidation.⁴

The strength of Mr. Kester's recommendation for consolidated statements is of significance and Mr. May's comment regarding the formation of subsidiaries merely as a matter of convenience points out a danger inherent in the acceptance of the legal entityship approach. Mr. May's

¹Sidney I. Simon, "Consolidated Statements and the Law," The Accounting Review (October, 1953), p. 514.

²"Findings and Opinions," Journal of Accountancy (October, 1942), p. 380.

³Ibid.

⁴George O. May, "The American Car and Foundry Decision," The Journal of Accountancy (December, 1942), p. 519.

final comments provide a specific illustration for the contentions of Mr. Simon. He added that the decision turned too largely on special facts and on the form of presentation to have any wide accounting significance.¹

The same case provoked the repetition of a resolution made many years before in which an eminent practitioner proclaimed that he would never look at an enterprise from a legalistic point of view.²

The following criticism of the courts and the reversal of the roles of the statements of sub-units and the economic entity are indicative of a change in attitude as revealed by one theorist on page 87.

As a matter of fact the courts have apparently lagged so far behind developments in financial structure that consolidated statements are forced into a secondary role in many instances. From the point of view of the financial community, these roles should apparently be reversed--the statements of each constituent unit of a consolidation are schedules in support of the major exhibit, the consolidated statement.³

The following statement of the purpose of consolidated statements, the manner of its achievement and the relationship of the economic entity to the rest of the world is probably the best summary of its kind.

The essential purpose of consolidated statements is to display the income record and financial position of two or more associated companies as if they represented a single enterprise. Consolidated statements

¹Ibid., pp. 521-522.

²Robert H. Montgomery, "Is the Profession Going Legalistic," Journal of Accountancy (December, 1942), p. 523.

³Maurice Moonitz, "Accounting for Parent Company's Investments in Subsidiaries," New York Certified Public Accountant (May, 1946), p. 229.

disregard--or minimize--legal lines of cleavage and stress managerial unity. In such reports the overlapping, intercompany accounts are canceled and a picture is drawn of the affiliation--the family of companies--in its over-all relation to the external business community.¹

According to Mr. May it would be difficult to overemphasize the importance of consolidated statements.

The accountant should insist that parent company accounts, prepared on what is called (perhaps wrongly) a legalistic basis, are often inadequate to disclose even the financial position and results of operations of the parent company unless accompanied by and read in conjunction with consolidated accounts or some other form of presentation of the results of the operations of the subsidiaries.²

The fact that separate statements for a parent or its subsidiaries may sometimes be misleading or even distorted as a result of the effect of intercompany transactions and the impropriety of omitting subsidiaries from consolidation when their financial position and operating results might discredit the over-all showing is emphasized by another writer.³ An article has cautioned bankers and investment advisers not to be misled in situations where unconsolidated subsidiaries exist.⁴

The problem as seen by the American Institute is voiced in the following manner.

¹W. A. Paton and W. A. Paton, Jr., Corporation Accounts and Statements (New York: The Macmillan Company, 1955), p. 573.

²May, op. cit., p. 520.

³Carman G. Blough, (ed.), "Current Accounting and Auditing Problems," Journal of Accountancy (November, 1949), p. 440.

⁴West, op. cit., p. 3.

Consolidated statements. In this area, it appears that more uniformity is needed regarding inclusion of specific affiliates or groups of affiliates in consolidation. There is considerable flexibility in this area at present, resulting in substantial lack of comparability.¹

Conclusions

The author of this thesis submits the proposition that since the courts have had no intention of establishing premises that may be used in the development of accounting theory, legal lines of cleavage as a deterrent to the development of the concept of the economic entity be dismissed. This supplements his earlier advocacy of the abandonment of the legal concept of the individual corporation when it tends to obscure its economic function.

¹"Comments, Suggestions Invited from Members on Intercorporate Investment Research Study," op. cit., p. 3.

CHAPTER VII

REQUIREMENTS FOR CONSOLIDATION

Percentage of Ownership

In Chapter II the criteria used to determine whether or not a parent's accounts should be consolidated with those of its subsidiaries were considered. In conjunction therewith, the pronouncements of various regulatory organizations were reviewed. The pronouncements suggested the ownership of a majority of the voting shares of the subsidiary by the parent as a primary condition for consolidation. There were qualifications to this requirement, but the qualifications usually stressed the non-inclusion of a subsidiary whose voting shares were more than 50% owned, under certain conditions. At that time, the lack of attention paid to situations of an opposite nature was not emphasized. The statistical summaries presented in Chapters II and III indicated that the 50+% rule of thumb was accepted, if anything, too literally. As a matter of fact, it seemed as though nothing less than complete voting control was sufficient to convince most parent companies that an economic entity existed and, therefore, consolidation was in order.

The paradox of demanding one course of reasoning while admitting the possibility of another is nowhere more evident than in the regulations promulgated by the Securities and Exchange Commission. Reference to page 19 of Chapter II of this thesis reveals that the Commission insists upon

majority ownership before consolidation may be considered for its purposes.

Its definition of control contradicts the above stipulation.

Control. The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a corporation, whether through the ownership of voting securities, by contract, or otherwise.¹

For example, it is possible to control a corporation by contract, but if this is not accompanied by a majority ownership of the voting shares, consolidation should not be effected, according to the Regulation.

A more reasonable approach to this matter is expressed by an educator who agrees that consolidation is in order whenever the parent corporation has sufficient ownership of the subsidiary's outstanding shares to enable the parent to control the subsidiary, but who recognizes that ownership of less than 51% of the outstanding shares may produce this result.²

Mr. Fellner's comments on pages 63 and 68 in reference to minority control appear to be apropos at this juncture. While his prime consideration was the control exercised by individual stockholders, or groups of stockholders, there seems to be little reason to believe Mr. Fellner would object if an extension were made to include corporate shareholders, as well.

¹Regulation S-X, op. cit., p. 1.

²Miller, op. cit., pp. 317-318.

Probably the best over-all statement of the requirement of control encountered in this project is contained in the comments that follow.

The necessary condition for unified operation of a group of corporations is centralized control. Control is most easily centralized by domination of the board of directors of each company; and this domination is most readily and firmly secured by possession and exercise of the votes needed to elect the board. . . . The error must be avoided, however, of confusing the reflection with the object, of identifying share ownership with control. . . . "Control" as such lacks objective manifestations, a condition which the formulation of standards should seek to remedy. . . . Consequently, as a determinant of a parent-subsidary relationship majority ownership of voting stock is a useful test.¹

Majority ownership, then, is indeed a useful test but not an ultimate criterion.

It is suggested that there are undoubtedly many instances of control accompanying minority ownership of the voting shares. One source suggests consolidation when there is minority stock ownership of twenty-five per cent or even less if operating control is assured over a long period, especially if the remaining shares outstanding are represented by a large number of small holdings.²

Another writer lists the following possible methods of achieving a position of control although a minority of voting shares is owned by the controlling party:

¹Moonitz, The Entity Theory of Consolidated Statements, op. cit., p. 21.

²W. A. Paton and W. A. Paton, Jr., Corporation Accounts and Statements, op. cit., p. 577.

1. Ability to obtain proxies from other stockholders.
2. Inactivity of stockholders who take no part in meetings, by attendance or through proxies.
3. Ownership of voting stock by subsidiaries, directors, officers, employees, nominees, of other persons having subordinated interests.
4. Possession of a lease or other contract with a corporation which carries with it the virtual ownership of the corporation's assets without any necessary ownership of capital stock.¹

In some instances, what appears to be minority ownership may become majority ownership for all practical purposes. For example, the possession of a sufficient number of proxies may result in this change of status. But it cannot be denied that initiative still is in possession of the minority which obtained the proxies. Moreover, even after the assignment of proxies, control may still be vested in a group that possesses only minority ownership.

Mr. Moonitz admits that the exact voting strength may be obscured by indirect ownership, voting trusts, nominees, shares in the names of directors, and the like² but feels that consolidation is not proper unless the minority holding carries with it complete domination of the board of directors and the continuing power to carry its policies into action.³

¹E. L. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," Accounting Review (March, 1938), p. 64.

²Moonitz, The Entity Theory of Consolidated Statements, op. cit., p. 24.

³Ibid., p. 26.

It is difficult to understand the reluctance expressed in the above statement. Probably the most unchanging aspect of our society is change. This is particularly true of its business segment. Comments have been made about this characteristic throughout this paper. The evidence of continued flux presented by Mr. Harris and others, as well, should be convincing. Why then is it necessary for the minority to possess "continuing power"? No such request is made of a majority and yet the possibility of eventual loss of power surely exists for it. A demand of this nature does not seem to be reasonable or logical.

The concern over lack of control in situations where 50+% ownership of voting shares exists is expressed by Mr. Paton when he states that:

. . .With a bare majority of shares, of course, the controlling interest is skating on thin ice, especially where cumulative voting for directors is permissible under the bylaws. The existence of senior securities which are convertible into common stock may also jeopardize a control which rests on a bare majority.¹

If criticism of eventualities is justified in minority control situations it is also justified in majority control situations. The fact that there is control at the time of preparation of the financial reports is all that matters, even if there is cumulative voting and/or the existence of convertible senior securities. The cumulative voting privilege may at

¹W. A. Paton and W. A. Paton, Jr., Corporation Accounts and Statements, op. cit., pp. 576-577.

some future date oust the present majority from its position and the conversion of senior securities into voting shares may produce the same result but, then again, they may not. There is even a possibility that the hand of the majority will be strengthened by the exercise of these options.

Mr. Kohler delineates certain situations where majority ownership may not be accompanied by control. He mentions temporary ownership, a strong management and a contractual relationship with a creditor or other outsider.¹

Comment has already been made about the possible effects of temporary ownership. It may be that the "strong individuals" referred to follow policies consistent with the desires of the controlling interests, as suggested earlier by Mr. Fellner. It is true that contractual relationships may restrict the operational latitude of the owners but often these arrangements are only temporary and it seems as illogical to claim loss of control on this pretext as it did to claim lack of it when temporary ownership existed. Moreover, the restriction referred to may not be severe enough in any event to warrant an allegation of loss of control. Finally, if the controlling shareholders entered such agreements voluntarily can loss of control be seriously asserted?

A later sentence by Mr. Moonitz states the obligation of the accountant to describe carefully the tests employed to establish centralized

¹Kohler, "Some Tentative Propositions Underlying Consolidated Reports," op. cit., p. 64.

control.¹ The only reasonable conclusion seems to be that the attempt to establish a general standard stating the percentage of stock of an affiliated corporation that must be owned to warrant consolidation is not justified.²

That majority ownership is not adhered to in all practical situations is attested to by the following quotation.

Our answer to this problem is that we have clients who, according to their bylaws, consolidate companies in which they own less than 70 per cent, and in the case of one of our clients, its corporate structure provides that it should consolidate the operations of any companies in which it owns a 10 per cent or greater interest.³

There are even circumstances under which it was considered advisable to consolidate a partnership with several corporations whose stock it owned.

Case No. 1. I believe that it would be permissible and proper to prepare and render an opinion on a balance-sheet consolidating the assets and liabilities of the partnership and several subsidiary corporations.⁴

Another situation is described below.

¹Moonitz, The Entity Theory of Consolidated Statements, op.cit., p. 27.

²Hepworth, Reporting Foreign Operations, op. cit., p. 160.

³Accounting Questions, "Percentage of Ownership Required for Consolidation," Journal of Accountancy (June, 1941), p. 533.

⁴Accounting Questions, "Consolidation of Partnerships with Subsidiary Corporations," Journal of Accountancy (August, 1941), p. 174.

Case No. 2. Several of our corporate clients have found it advisable to create operating partnerships in which the holders of common stock became members. The corporations have been continued for the purpose of holding title to buildings, equipment, etc., and these are rented to the partnerships. The interests of the partners are not necessarily proportionate to their common-stock holdings. The only purpose of the partnership is to minimize income taxes.¹

An answer to the question approved the preparation of consolidated balance sheets including the corporations and partnerships involved.²

Under the proprietary theory the corporation exists for the immediate benefit of all the common stockholders. At any one time a particular group will be in control. The group in question may be in the majority but it could also be a minority faction. This does not necessarily mean that the policies of the corporation will be contra to the desires of the "out group," but if they are it is only a characteristic of a culture in which the group that seizes control rules. At some other time the present "out group" may even become the "in group." Since the corporation is an instrument of society, the society decides the limitations of its operational latitude. Therefore, the corporation exists for the ultimate benefit of society. Social pressures will, in the last analysis, force it to conform to a certain standard of conduct. These pressures need not be legalistic in nature although the legal mechanism often is the instrument of enforcement. These observations are true whether the common shareholder is an individual or another corporation.

¹Ibid.

²Ibid.

The only relevant situation in regard to control is the situation that exists at the time financial reports are prepared. It is the responsibility of the accountant to determine what that situation is and to proceed accordingly. He may even decide to consolidate different forms of business organization, if the situation warrants such action.

Homogeneity

The pronouncements discussed in Chapter II suggested homogeneity of operations as a criterion for the preparation of consolidated statements. This position was qualified to some extent in recognition of the trend towards diversity in American industry. Nevertheless, the table on page 30 lists non-homogeneous operations as the second most important reason for the nonconsolidation of subsidiaries.

Throughout the literature there seems to be some confusion between the terms "homogeneous" and "integrated." For example, in the following quotation there appears to be a degree of ambiguity connected with their use.

2. Consolidated financial statements have more significance where the subsidiaries are homogeneous with the controlling company or with each other. . . . The strongest case for consolidated statements is the situation where a parent company and its wholly owned subsidiaries together constitute an integrated line of endeavor under a common management.¹

¹Kohler, "Some Tentative Propositions Underlying Consolidated Reports," op. cit., p. 64.

According to another source, the emphasis seems to be on integration although the use of the word heterogeneous casts some doubt on the validity of this interpretation.

A composite picture of the affairs of a group of companies which are closely integrated or allied in their activities obviously has more significance than a joint report for a heterogeneous collection of enterprises. Indeed, where two or more companies have no operating relationships whatever the preparation of consolidated statements may be unwise even if affiliation is complete as far as ownership and ultimate control are concerned.¹

Mr. Moonitz makes his point of view quite plain.

In cases of complete or partial vertical integration through shareholdings, is consolidation of all controlled companies to take place or is it to be restricted to companies within a given industrial sector? . . . Again the important consideration appears to be whether or not the affiliated companies carry on extensive intercorporate operations. If they do, noninclusion cannot be argued, as with the bank, on the grounds of virtual exclusion from consolidated affairs.

As an example, assume an automobile company controls a body plant, a glass factory, a steel company, a woodworking corporation, a sawmill, and an installment finance agency. Provided all the constituent units are closely linked in operations, and provided they deal almost exclusively with each other and only incidentally with other enterprises, an integrated area of operations exists and, despite the dissimilarity of functions performed, consolidation appears to be in order.

. . . In addition to control truly integrated or related operations must be present.²

¹W. A. Paton and W. A. Paton, Jr., Corporation Accounts and Statements, op. cit., p. 579.

²Moonitz, The Entity Theory of Consolidated Statements, op. cit., pp. 30-31.

The stress in The Entity Theory of Consolidated Statements is on integration rather than homogeneity.

The relevance of homogeneous operations has been discussed under the heading "Business Combinations." In Chapter V it was pointed out there is very little concern over the non-homogeneity of operations of a corporation that has diversified its operations. Moreover, there is the same lack of objection to the preparation of statements for the business entity that arises from a merger or consolidation. If a parent-subsidiary relationship is merely one form of business combination the same considerations should apply to it as to any other business combination. The idea of homogeneous operations has been rejected in some quarters for many years as evidenced by the following comments.

. . . subsidiaries not homogeneous with the controlling company should not be included in consolidated statements. This point has been overemphasized. The heterogeneity of activities of a single corporation does not cause accountants to exclude the assets, liabilities, and operations of such activities from the corporate statements. Net income is net income, regardless of the nature of the activity producing it.¹

Nineteen years later, a practitioner reflected the same viewpoint in his comments relative to the inapplicability of the criterion of integrated operations in the face of efforts to diversify on the part of most companies.²

¹H. W. Bordner, "The Accounting Exchange," The Accounting Review, (September, 1938), p. 291.

²John Peoples, op. cit., p. 133.

The desire for comparability is often the basis for the insistence on homogeneous and/or integrated operations as a criterion for consolidation. A refutation of this reason is presented by another writer who asserts that if companies are not comparable, the attempt to compare their financial statements is illogical.¹ He continues by condoning the use of different accounting methods to reflect basic differences, if the methods are based upon generally accepted accounting principles and states that the use of adjustments to make otherwise incomparable statements comparable is in error.²

Comparability is a worthwhile objective. However, if its emphasis will result in the subordination of other more worthwhile objectives, comparability should be relegated to a secondary position. It is difficult to make valid inter-temporal comparisons of the same economic unit because of the changing nature of its activities. It is even more difficult to make inter-unit comparisons in the same time period because of the individuality associated with each unit. Moreover, purely technical considerations compound the problem. Among them is the range of alternative accounting practices applicable to a particular situation.

The criterion of homogeneous and/or integrated operations seems to have been established with the objective of comparability in mind. It is recognized that this may not have been the only reason for the emphasis

¹Patrick S. Kemp, "Controversies on the Construction of Financial Statements," The Accounting Review, (January, 1963), p. 131.

²Ibid

of this characteristic. Nevertheless, the criterion severely restrains the development of the concept of economic entity. It is a restricting idea that is not in keeping with the facts of present day business life. Its promoters never took the trouble to adequately support it and there is evidence that it was never fully accepted. It is suggested that the criterion of homogeneous and/or integrated operations be abandoned when it results in an inadequate presentation of the economic entity. The following excerpt summarizes the approach advocated. It will be noted that even here it would be difficult to compare the consolidated statements of the manufacturing companies with those of any other manufacturing group. Attention is directed to the reference to practice.

A well-known credit company in its annual report presents consolidated balance-sheets for three controlled groups: Manufacturing companies, insurance companies, and the parent and its finance companies. Consolidated operating statements are presented for each of the three groups and also for the three groups combined. It is interesting to note that the manufacturing subsidiaries which are consolidated operate in seven different fields. This does not seem to be particularly unusual among manufacturing companies. Whether the operations of controlled manufacturing companies are integrated or are relatively uncomplementary to each other appears to have little influence in practice on the question of consolidation.¹

¹Carman G. Blough, op. cit., p. 439.

CHAPTER VIII

MISCELLANEOUS MATTERS

Minority Interest

It has been suggested that the social institution theory be accepted as the proper concept of the corporation, with the proprietary theory as its base. In the interest of consistency, the application of the same viewpoint to business combinations, including the parent-subsidary relationship, has been advocated. However, the paramount importance of economic considerations in establishing the dividing line between business entities has been stressed throughout this paper. It was maintained that there need be no conflict between the proprietary concept of the corporation and the enterprise concept of the economic entity; indeed they support each other. If the corporation is an entity, it cannot be part of another entity. If the corporation is the instrument of its owners, and the owner is another corporation, the subsidiary is a part of a larger economic unit, the business enterprise.

One aspect of this line of reasoning which deserves special consideration is the position of the noncontrolling shareholders. There have been references to this group in the course of development of the ideas relative to the corporation in Chapter IV. The position of the noncontrolling shareholders of a subsidiary is considered in this section.

While discussing the affiliation of the parent and subsidiary corporations one writer observes that there must be a shift in viewpoint

from that of a legal abstraction to that of an accounting abstraction.¹ If the accounting abstraction is emphasized it is desirable to distinguish between transactions with affiliates and those with outsiders.²

The deduction that the transactions that occur within the economic entity are of a different nature than those that do not is of special significance to the noncontrolling shareholders.

The severance of Mr. Moonitz' philosophy from that previously accepted by many other theorists and practitioners is emphasized by the function ascribed to the consolidated balance sheet. According to one journal contributor, Mr. Moonitz maintained that the consolidated balance sheet is not a parent company statement, but that it represents two proprietary interests.³ In reference to its basic nature Mr. Nowak asks whether the consolidated balance sheet is made up on the assumption that the related companies are in effect one company or whether there is a substitution of underlying assets and liabilities for the investment account of the parent company.⁴

His questions are answered by another writer whose views are essentially antagonistic to those of Mr. Moonitz, and who therefore claims

¹Moonitz, The Entity Theory of Consolidated Statements, op. cit., p. 84.

²Ibid.

³George J. Nowak, "What to Eliminate in the Preparation of Consolidated Balance Sheets," Journal of Accountancy, (July, 1947), p. 37.

⁴Ibid.

that a process of substitution takes place rather than one of combination.¹ He further ascribes misconceptions in this area to lack of recognition of this principle.²

The adherents to this viewpoint argue that the consolidated statements essentially are the statements of the parent company and not those of an accounting entity. Hence, the underlying assets and liabilities of the subsidiary may be substituted for the investment account of the parent in the preparation of consolidated reports. The ultimate expression of this line of reasoning was stated at least as far back as 1938.

In the earlier days of consolidated financial statements, it was the view of some that only that portion of the subsidiary's assets and liabilities which represented the parent's ownership should be included in the consolidated balance-sheet.³

The conclusion is that the minority interest, as it is called, need not consult the consolidated statements for information relative to its investment. The protagonists of the entity theory refute the argument that consolidated statements are the statements of the parent company but place the minority interest in a unique position.

¹J. D. Campbell, "Consolidation vs. Combination," The Accounting Review, (January, 1962), p. 101.

²Ibid.

³Edward A. Kracke, "Consolidated Financial Statements," The Journal of Accountancy, (December, 1938), p. 377.

Consolidated statements are prepared despite the presence of minority interests. Minority equity must be indicated, however, to avoid an overstatement of the size of the controlling equity. Minority interests in consolidated capital and income are to be computed after consolidated adjustments are made and not on the basis of a subsidiary's unadjusted records.¹

A more complete statement of the position of the minority interest follows:

In general, presumably, outside or minority stockholders of subsidiaries will not receive any information of direct benefit to them from consolidated reports. As consolidated groups function the outside shareholders are mere passive participants in the combination. The fate of their investment is almost completely at the mercy of the controlling group. This is not meant in any sense invidious to the group in control but in the simple and obvious sense that in matters of business policy the outside shareholders must accept the decisions of the controlling group. The participation by outsiders may be profitable to them--their anticipations probably run along these lines--but nevertheless they are in no position, legally or economically, to direct the ordinary course of business events impinging on their investments. To these shareholders the statements of immediate direct interest are those of the legal entity whose stocks they own.²

These observations are supported by the contention that minority interests in subsidiaries' stock take on many of the aspects of indebtedness,³ and that outside shareholders and their shares of the surplus accounts on the

¹Moonitz, *The Entity Theory of Consolidated Statements*, op. cit., p. 85.

²Ibid., p. 13.

³William W. Werntz, "Some Problems as to Parent Companies," Journal of Accountancy, (June, 1939), p. 340.

consolidated balance sheet should be regarded as liabilities rather than as net worth.¹

There is little evidence that any authority regards the interests of the noncontrolling common shareholders of an individual corporation as liabilities or quasi-liabilities under the proprietary theory. There are also few, if any, allegations that any of the common shareholders of the corporations which lose their identity in a merger of consolidation are considered in this light. It has already been established that a parent-subsidiary relationship is merely one form of business combination and that it shares many of the characteristics of other forms of combination. Is it possible then to regard the noncontrolling shareholders of a consolidated entity as a species of creditor and still be consistent with the attitude generally expressed toward noncontrolling shareholders?²

It is not strange for the noncontrolling group to accept the decisions of the controlling group in a democracy. The interests of the two groups need not contradict each other. If the "fate of their investment" is in the hands of the controlling group is it not normal for the noncontrolling group to be curious about the policies and, more important, the performance of that group? What better source of information of this nature exists than the consolidated statements? Finally, are not the noncontrolling shareholders of the subsidiary, shareholders in the economic entity?

¹Kohler, "Some Tentative Propositions Underlying Consolidated Reports," op. cit., p. 68.

²Ibid., p. 66.

With increased public interest in the corporation as a result of the broadening base of share ownership is it still possible to assert that the aforementioned group and the public regards the noncontrolling owners as quasi-creditors?

The attitude taken towards intercompany transactions is strongly influenced by the theoretical position occupied by the noncontrolling shareholders of subsidiary corporations.

The leading principle in the technique of preparing consolidated statements is the elimination of all evidences of intercompany relationships. . . . The objective attained by elimination is the suppression of amounts and accounts reflecting transactions among the constituent units and the retention of only those data pertinent to the showing of the affiliation as an economic or business entity.

3. Assets obtained from affiliates must be shown at cost (or other conventional basis) to the entire affiliation viewed as an accounting unit, regardless of the size of minority interest. Specifically, this calls for inclusion of inventories and fixed assets at amounts freed of any trace of intercompany net gains or losses. Likewise, cost of goods sold and depreciation should be included on a fully consolidated basis not influenced by minority interest.¹

The position stated above is supported by Mr. Kohler.²

Various authors have agreed with this stand, giving as their reasons the fact that "there is no increase in value when goods are

¹Moonitz, The Entity Theory of Consolidated Statements, op. cit., pp. 84-85.

²Kohler, "Some Tentative Propositions Underlying Consolidated Reports," op. cit., p. 66.

transferred from one affiliate to the other"¹ and "there is no 'realized' profit arrived at in an objective or arms-length transaction,"² or "that no transaction between corporations within the group can of itself be productive of income to the group or to the parent company."³

On the other hand, it contended that only that part of the profit accruing to the parent company as a result of intercompany transactions should be eliminated. This position assumes that a consolidated balance sheet reflects the minority interest at its value on the books of the subsidiary.⁴

When one company sells merchandise or assets to a related company, the parent company--which controls the organization and looks upon the subsidiaries as departments of the organization--should not consider the profit made by a subsidiary as realized until the goods have been resold to an outside purchaser. The minority interest, however, has a right to its share of the profit since the goods have been sold to a company in which they have no interest.

The conclusion in respect to the elimination of intercompany profit in inventories, notwithstanding the existence of the concept promulgated by Mr. Moonitz, is that the profit should be eliminated to the extent of the percentage of stock of the selling subsidiary held by the related company.⁵

¹Peoples, op. cit., p. 34.

²Carman G. Blough (ed.), "Accounting and Auditing Problems," Journal of Accountancy, (October, 1959), p. 70.

³May, The American Car and Foundry Decision," op. cit., p. 519.

⁴Accountants Handbook, op. cit., p. 1090.

⁵Nowak, op. cit., pp. 37-38.

This proposition is consistent with the excerpt from Mr. Krackes' article and like it is destructive of the concept of the economic entity.

If the proprietary theory is accepted, all common shareholders have an ownership interest in the economic entity. Whether they are controlling or noncontrolling shareholders of the parent company or noncontrolling shareholders of the subsidiary company is of no consequence. It necessarily follows that only transactions with entities outside the particular entity in question can be productive of profit.

Valuation of Investment in Subsidiary

Alternatives.--The method employed in the valuation of the parent company's investment in the subsidiary company is important because it may reveal the concept of the consolidated entity accepted and that of the corporate entity, as well. Ideally, the two should be consistent with each other.

It should be worthwhile to consider the alternative methods available and to select from them the one which seems most appropriate to the theory accepted. The most frequently suggested methods are listed in an article.¹ The simplest method is initial entry at cost, with subsequent entries only for purchases and sales, partial liquidation of capital, reorganizations and events of similar nature. Another method is initial entry at cost with subsequent adjustments for changes in the proprietary equity of the subsidiary, usually to record the parent company's share of profits and dividends. Still another method is to record the initial

¹Moonitz, "Accounting for Parent Company's Investments in Subsidiaries," op. cit., pp. 234-235.

investment at book value, according to the figures in the subsidiary's records, and to adjust it for subsequent changes in this figure. Finally, the investment may be initially recorded at fair market value and adjusted periodically to the then existing fair market value. There are variations to the approaches considered in the article, but they are not important enough to be discussed here.

Because the value of an investment in an uncontrolled company is, for practical purposes, beyond the control of the investor the conventional cost rule is usually employed in its valuation. Market value is frequently exhibited parenthetically. The question of whether the investment in a controlled subsidiary should be similarly treated arises. According to one line of reasoning, it should be treated differently.

The value of the investment now turns in large part on the results of the subsidiary's operations, operations which are as much under the control of the parent as under its own.

Complete recognition of this situation, it seems to me, requires that we adjust a parent's investment accounts to reflect all changes in the fortunes of the subsidiaries. . . .¹

Criticism of the "Adjusted" Method.--It seems fair to contend that the entity theory of consolidation is properly based upon the proprietary theory of the corporation. In a lengthy footnote to Chapter V of Moonitz's Entity Theory of Consolidated Statements, wherein the author suggests adoption of the second method of valuing the investment account, Mr. Paton criticizes this approach and points out the inconsistency inherent in its use if the entity theory of the corporation is accepted.

¹Max Zimmering, "The Entity Theory of Consolidated Statements," Accounting Review, (January, 1946), p. 97.

Early in this study the author concludes that "consolidated statements must be regarded as auxiliary, special-purpose reports, not primary, all-purpose exhibits supplanting or displacing the statements of legally recognized entities." In his effort to demolish the cost basis of accounting for investments he seems to forget that his proposal is not entirely consistent with the earlier basic conclusion.¹

He proceeds by advocating the cost basis of accounting for investments with a recognition of income thereon as realized.²

In another of his numerous publications, Mr. Paton continues his assault on the practice of adjusting the investment account. Referring to the assumption that the value of the investment changes as the subsidiary earns income or suffers losses, he says,

With respect to the first point it may be objected that the cost of the investment--market value at date of acquisition--is not likely to coincide with the amount on the subsidiary's books (except where the investment is made at date of issue) and the increase (or decrease) in subsidiary book value through retention of earnings (or the effect of losses) cannot be expected to match the changes in market value.³

It is evident that Mr. Paton views this approach to valuation as an attempt at approximating the market value of the investment. He continues by asserting.

In other words, the corporate stockholder, like the individual investor, does not realize income on his investment until dividend action is taken, and dividend action does not necessarily result from the earning process or--if taken--provide for a distribution matching the current income figure.

¹Moonitz, The Entity Theory of Consolidated Statements, op. cit., p.46.

²Ibid., p. 47.

³Paton and Paton, op. cit., p. 582.

Assuming that consolidated statements are being prepared there is a further technical objection to the practice of "soaking up" subsidiary earnings by adjustment of the investment account on the parent's books. The main purpose of consolidated statements is to show the performance and position of the two or more associated companies as a whole, and if the accounts and statements of the dominant company are handled in such a manner as to disclose therein the consolidated earning picture there is not much point in proceeding further with the complex process of consolidation proper.¹

He concludes by attacking the idea of recording a proportionate share of income or loss in the investment account as being detrimental to the concept of consolidation.

Mr. Paton is correct about the contradiction inherent in Mr. Moonitz' treatment of the investment account if the entity theory of the corporation is accepted. It is also evident that he prefers the entity theory of the corporation to the proprietary theory as revealed by his remarks about subsidiary earnings and dividends. Mr. Paton does not appear to recognize that the strict corporate entity theorist is precluded from accepting the concept of the economic entity without compromise. His remarks about the main purpose of consolidated statements are of special significance. They will be considered further at the end of this chapter.

Elimination of Discrepancy Between Cost and Book Value.--

Presumably in answer to his critics, Mr. Moonitz attempted to resolve the issues raised by his approaches to investment account valuation by suggesting that the discrepancy between cost and book value be analyzed with the

¹Ibid., p. 583.

objective of removing it completely at acquisition date through the medium of adjusting entries. He classified the reasons for discrepancy as follows.

1. The valuations attached to specific assets or liabilities of the subsidiary may be inadequate.
2. Premium or discount may exist on the parent's securities issued to acquire control.
3. The parent may have sustained a loss or realized a profit on the acquisition of the subsidiary's shares.
4. Unrecorded intangibles may attach to the subsidiary.¹

In the discussion that follows Mr. Moonitz emphasizes the crucial position assigned to unrecorded intangibles, primarily goodwill, in the revaluation of the net assets of the subsidiary. He suggests that the entire goodwill be recorded on the books of the subsidiary and claims that "the magnitude of goodwill is not affected by the proportion of stock acquired by the parent."² Another publication sums up his argument clearly:

The going value [goodwill] does not exist because the payment exceeds the book value--on the contrary the payment exceeds the book value because the going value presumably exists. And if \$30,000 has been exacted as the price of the going value of a 60% equity it is because the total going value is \$50,000. . . .

The going value of the subsidiary does not depend in any manner upon the price paid by the parent company for an equity. On the contrary, the price paid by the parent company is influenced by the preexisting going value of the subsidiary.³

¹Moonitz, "Accounting for Parent Company's Investments in Subsidiaries," op. cit., p. 230.

²Ibid., p. 232.

³Accountants Handbook, op. cit., p. 1080.

Mr. Moonitz also dismisses the contention that since the goodwill has not been paid for it should not be recorded by the subsidiary company. Its future disposition is indicated in this remark. "If the subsidiary does prove highly profitable the existence of goodwill is substantiated and it should be amortized or not in accordance with the principles applicable to good will in general."¹ His original position on the adjustment of the investment account is reaffirmed.

At this late date no extended discussion is needed to make the obvious point that a parent's cash receipts from subsidiaries against dividend declarations in a given year is no measure of the income earned from investments in that same year. Absurd results flow from the attempt to follow the manifestly incorrect tax rule that an investor has no income from stocks until a dividend is declared.²

It is hypothesized that Mr. Moonitz' unadmitted intention is to record the investment in the subsidiary on the books of the parent at its market value, which is its cost, at the date of acquisition and to adjust it periodically for any changes in this figure. To accomplish this end it is necessary to record the adjustments referred to in the accounts of the subsidiary at the date of acquisition and to readjust the accounts from time to time, primarily through the technique of adjusting the goodwill account on the books of the subsidiary. Revaluations will find their way into the investment account as adjustments of the parent's share of profit entered therein and through the medium of adjusting entries on the books of the parent.

¹Moonitz, "Accounting for Parent Company's Investments in Subsidiaries," op. cit., p. 232.

²Ibid., p. 233.

If subsequent operating results indicate the absence of intangible values, the goodwill should be scaled down or written off entirely in the same fashion as is would be if the subsidiary were not part of a consolidation. The additional feature of interest is the effect of such a write-off on the parent's investment account. The reduction in equity behind the investment requires that it be scaled down proportionately against earned surplus of the parent.¹

Mr. Moonitz has advanced the proposition of adjusting the goodwill account to reflect changes in the operating results of the subsidiary. It is suggested that to be consistent, adjustments of all accounts involved are required. If such adjustments are warranted at the date of acquisition it seems logical to expect their use at later dates.

It is common knowledge that the accountant recoils from adjustments of this nature and it may be this attitude which prevents the acceptance of ideas similar to those expressed above by Mr. Moonitz. Hence, he reverts to a "practical approach" which consists of recording the investment at cost and adjusting it for its share of changes in the proprietary equity of the subsidiary. Among his justifications is the following remark.

Admittedly, a complete, reliable, appraisal of the subsidiary is difficult to obtain, consequently it is usually not known what factors accounted for a discrepancy between price paid and book value of equity acquired. As in other similar cases in accounting where uncertainty with respect to present status of future developments is present, refuge may be had in the safe practice of recording at cost.²

¹Ibid., p. 232.

²Ibid., p. 236.

The supporters of the adjusted method of exhibiting the investment account apparently are more concerned with the right of the parent to its share of the undistributed earnings of the subsidiary than they are with the question of whether it is proper or even possible to carry the investment at market value accompanied by appropriate adjustments of the net assets of the subsidiary. Thus, one writer rejects the idea that no income should be recorded by the parent until it receives dividends from the subsidiary by claiming that it rests on considerations of realization and objective determination and that such considerations do not apply in the relationship described.¹ Another author contends that if the investment account is carried at its cost to the parent the conclusion is that the "legal entity" theory has been accepted.²

There seems to be little cause for concern over the question of the right of the parent to its share of subsidiary profits. By virtue of its control of the subsidiary, the parent, in the absence of contractual restrictions and presuming sufficient retained earnings, can force the subsidiary to declare dividends at any time.³ If the subsidiary is unable to pay the dividend at the designated time the parent can lend it the cash with which to do so.⁴

Unfortunately the practical approach is a compromise. The methods advocated under it to adjust the investment account to some semblance of market value seem to be crude and ineffective at best.

¹May, "The American Car and Foundry Decision," op. cit., p. 521.

²"Findings and Opinions," op. cit., p. 381.

³Moonitz, "Accounting for Parent Company's Investments," op. cit., p. 233.

⁴Ibid.

Moreover, if conversion of the investment account from a cost basis to an adjusted value is desired, it is always possible if pertinent information is revealed in footnotes to the parent company's financial reports. Market value may be exhibited parenthetically.

Assuming that consolidation is in order, the reasons for the ritual of recording the parent's share of undistributed subsidiary profits in the investment account are obscure. Perhaps it originated out of a desire to have one's cake and eat it by making the adjustment but not performing the operation of consolidation. There is additional reason to reject the process on the grounds of its inconsistency with the usual treatment of investments. In the final analysis, however, it is rejected because it does not accomplish the purpose for which it was intended, that purpose being an abortive, albeit frequently unadmitted attempt at valuation at market price; and the lack of necessity, since the act of consolidation itself accomplishes the objective of presenting the facts relative to the particular economic entity involved. Finally, the fact that there was no adjustment of the investment account for the parent's share of subsidiary changes in equity need not do damage to the proprietary concept of the corporation, acceptance of which is necessary for unqualified adoption of the concept of the economic entity.

Combining Statements

In discussing the problems of accounting for parent companies Mr. William Werntz, while stressing the importance of consolidated statements voices concern over the possible obscurement of the reports of the

individual corporations.¹ The preparation of consolidated statements need not result in the relegation of individual corporate statements to an unimportant position. Combining statements have been mentioned herein and it is suggested that their use be expanded. If possible, the operation of combining may be so performed as to emphasize homogeneity and/or integration, where they exist. However, the limitations inherent in each statement or group of statements should be pointed out and the basis for combination made absolutely clear.

Somewhat earlier examples of the consolidation of a partnership with a corporation were presented. That special circumstances brought about this unique mixture is admitted. However, a sophisticated observer may well find many instances where unusual conditions prevail. It may even be proper to prepare consolidated statements without the existence of a parent corporation.

It is no doubt possible for companies to be related without the existence of a dominant, parent corporation, but in this situation the burden of proof must certainly be sustained by the person who contends that consolidated statements are necessary; the presumption is to the contrary. This does not deny that a form of consolidated reporting may be employed in the case of an individual who owns a controlling interest in the shares of one or more corporations. But the dominant entity in this case is the individual owner, not a corporation, and the "consolidated statements" of an individual are outside the scope of corporate accounting.²

The observation that the "consolidated statements" described are outside the scope of corporate accounting cannot be used as an excuse for the

¹William W. Werntz, op. cit., p. 338.

²Paton and Paton, op. cit., p. 578.

non-recognition of an economic entity. The question once again is whether the accountant can afford to use a definition which does not cope with an existing situation. Mr. Moonitz once observed that:

According to Dewing the group in control of the DuPont Company, directly and indirectly, also dominates both General Motors Corporation and United States Rubber Company. But despite the unified control the three companies are not ordinarily considered as constituting a combination calling for the preparation of consolidated reports because the business operations of each company are distinct from those of the others. . . . And, in consequence, or rather in spite of the condition, each of these corporations is an individual business possessing a unity and an individuality of its own."¹

It is apparent that Federal Judge Walter LaBuy and the United States Justice Department did not agree with Mr. Moonitz or Mr. Dewing about the proposition of the individuality of each corporation as evidenced by Judge LaBuy's ruling ordering disposal of General Motors Corporation common shares by certain corporate, trust and individual holders.² Hence, despite Mr. Paton's admonitions to the contrary, there may be reasons for extending the practice of preparing consolidated statements beyond the limitations set in conventional accounting theory. This paper will not explore the possibility in detail because it extends beyond its defined limits.

¹Moonitz, The Entity Theory of Consolidated Statements, op. cit., p. 35.

²"DuPont Gets Set to do Some Stock-Shedding," Business Week, (March 10, 1962), p. 108.

CHAPTER IX

INCLUSION OF ACCOUNTS OF FOREIGN SUBSIDIARIES IN CONSOLIDATED STATEMENTS

Introduction

As a result of the evidence presented in Chapter VII, it was concluded that majority ownership of subsidiary voting shares was not a prerequisite to the preparation of consolidated statements for parent and subsidiary companies. Administrative control of the subsidiary was the criterion advanced. It was pointed out that control may exist even though there is less than 50 per cent ownership of the voting shares of the subsidiary. In the interest of consistency, the opposite situation of lack of control accompanying a greater than 50 per cent ownership of voting shares was admitted as a possibility and the consequent lack of grounds for consolidation accepted. It was further suggested that consistency be abandoned when its attainment interferes with other more worthwhile objectives, among them the fair reporting of the business affairs of an economic entity during a particular period. In this connection, it is hypothesized that there should be no compunction over the inclusion of a subsidiary that had not been included in the financial reports for the prior period and vice versa if a change in administrative control so dictates. Homogeneity and/or integrated operations were rejected as criteria for consolidation although their use in the preparation of combining statements was advocated if feasible. These opinions are in keeping

with the contention that the recognition of the changing character of business alignments is of greater importance than the adherence to concepts which are not capable of rendering this result, however laudable their other virtues may be. That this may culminate in additional responsibilities for the accountant is recognized, but their acceptance may result in greater awareness of his professional status by everyone concerned. The task of the present chapter is the determination of the applicability of the suggested criteria to subsidiaries located outside the national boundaries of the parent company.

Arguments Against Inclusion

Many theorists recommend the exclusion of foreign subsidiaries from consolidation except under conditions which clearly justify inclusion. Restrictions on the movement of funds from the foreign subsidiary to the parent company are often given as a primary reason for this attitude.¹ Another source cites as an additional reason, the location of the subsidiary's principal properties in a zone of military operations.² Still another writer adds the reasons of unfavorable legislation (without specifying its nature) and possible changes in the government of the nation in which the subsidiary is located.³ The underlying reason for concern over

¹Paton and Paton, op. cit., p. 579.

²Edwin J. B. Lewis, Consolidated Statements (New York: The Ronald Press Company, 1942), p. 227.

³Kohler, "Some Tentative Propositions Underlying Consolidated Reports," op. cit., p. 65.

the possible existence of the circumstances mentioned has been the availability of the assets and earnings of the subsidiary to the parent, as expressed in another book.¹ Since the usual mode of transference of assets among affiliates is through the payment of dividends² any interference in the process of declaration and payment may be interpreted as a possible justification for a decision not to consolidate.

In his arguments against the complete consolidation of Canadian subsidiaries, one journal contributor has contended that to do so is similar to the "inclusion in the current assets of any domestic company the amount of money it had deposited with the local city government to maintain a subway tunnel or a storage franchise?"³ This statement implies that except for that portion of the "deposited" assets which may be returned in the form of dividends control is irretrievably lost. The author permits himself this generalization while admitting that "nearly all of the earnings of a Canadian subsidiary could be withdrawn by dividend payments."⁴

The analogy drawn is defective in many respects. Among its more obvious criticisms is the observation that the assets of the subsidiary are the "working" assets of a "going concern." Moreover, as time passes the amount of dividends declared and paid may exceed the value of the investment

¹George Hills Newlove, Consolidated Statements (Boston: D. C. Heath and Company, 1948), p. 30.

²Miller, op. cit., p. 362.

³Albert G. Flume, "Problems in Foreign Trade Accounting," New York Certified Public Accountant (December, 1947), p. 819.

⁴Ibid., p. 818-819.

in the assets. Finally, administrative control of the subsidiary still exists in spite of the presence of certain restrictions on the withdrawal of profits. None of these statements apply very well, if at all, to the type of deposit referred to above.

The recorded proceedings of a conference held in Chicago on June 15, 1954, reveal the same reluctance by certain participants. A group antagonistic to the consolidation of foreign subsidiaries contended that "in view of the difficulty of receiving in dollars the investment in foreign subsidiaries any value placed on it was too tentative for inclusion in consolidated statements."¹

Pronouncements of Professional Organizations

The American Institute of Accountants issued its Accounting Research Bulletin No. 4 in December, 1939. The following recommendation was made in the Bulletin.

The disturbed conditions abroad, and the uncertain future, ...It is clear that in many cases in which statements of foreign subsidiaries have been consolidated with statements of United States companies, this practice can no longer be followed.²

A subsequent editorial in the Journal of Accountancy attempted to clarify the Bulletin by stating that the necessary prerequisite for consolidation seemed to be that all assets and earnings reported in consolidated statements should represent assets and earnings equally available to the parties of

¹Discussion Leader: Russell E. Westfall, "Accounting for Foreign Operations," NACA Bulletin, Section 3 (September, 1954), p. 188.

²Committee on Accounting Procedure, Accounting Research Bulletin No. 4, Foreign Operations and Foreign Exchange (New York: American Institute of Accountants, 1939), p. 1.

interest in the United States.¹ Moreover, it stated that a safe rule would be to report only earnings received in America.² It added, however, that each case should be decided on its own merits.³

Still later the following admonitions appeared in the Journal.

Before incorporating any foreign earnings in the income reports of American companies, the greatest care should be taken to ascertain that such earnings are or may be made available in the United States.

As to consolidation, the number of cases in which there is a basis for consolidation of foreign subsidiaries has become smaller.⁴

It is apparent that the Research Department was convinced the situation in regard to restrictions on the transfer of funds and the absence of effective rates of exchange had deteriorated sufficiently to justify the warnings expressed.⁵ To the extent that they dealt with the same subject matter there was agreement between the Bulletin and Accounting Series Release No. 11 issued by the Securities and Exchange Commission.⁶ The Release was perhaps more cautious than the Bulletin as evidenced by the following qualification.

¹Editorial, "Special Bulletin on Foreign Operations and Foreign Exchange," The Journal of Accountancy, (January, 1940), p. 1.

²Ibid.

³Ibid., pp. 1-2.

⁴Research Department, American Institute of Accountants, "Foreign Operations and Foreign Exchange," The Journal of Accountancy, (January, 1941), p. 27.

⁵Ibid.

⁶Editorial, "Consolidation of Foreign Subsidiaries," The Journal of Accountancy, (February, 1940), p. 82.

However, if, notwithstanding the existence of exchange restrictions and war conditions affecting certain foreign subsidiaries at the time the financial statements are prepared, the inclusion of such foreign subsidiaries in the consolidated statements is considered desirable and in the particular case will not prevent a clear and fair presentation of the financial condition and the results of operation of the registrant and its subsidiaries, their inclusion is ordinarily permissible.¹

It is evident that the outbreak of hostilities in Europe during 1939 influenced the pronouncements referred to above. Aside from the question of whether the extent of the reaction to the possible effects of war was justified there is the question of whether postwar developments should have produced a reversal of the trend revealed above.

Postwar Experience

Referring to the increasing stringency of exchange regulations, and the improbability of maintaining the then existing exchange rates at their current levels one writer suggested that the accounts of subsidiaries outside the Western Hemisphere should not be consolidated but that financial data be furnished in support of the relative investments.² The writer supported his position on the familiar grounds of unavailability of subsidiary assets and the belief that "To the average American a dollar is a dollar and if the accounts of a foreign subsidiary are expressed in terms of dollars for consolidation or statistical purposes, those figures should

¹Securities Exchange Commission, "Accounting Series Releases, Release No. 11, Consolidation of Foreign Subsidiaries and Domestic Corporations," (January, 1940), p. 1.

²A.B. Hecker, "How to Handle Foreign Currencies in Statements Covering Foreign Subsidiaries," Journal of Accountancy, (January, 1948), p. 26.

have some meaning. . . ."¹ Twelve years later reference was made to the continuing problems of instability of exchange rates, lack of currency convertibility and devaluation but little was said about restrictions.² It is also significant that Mr. Hecker refers to another occurrence of the day. "Another and more hopeful development is that foreign subsidiaries in former enemy and occupied countries have been returned to the control of United States parent companies. Of course, such control is purely nominal in the case of subsidiaries in countries dominated by the U.S.S.R., but for subsidiaries in Western Europe it has some meaning."³ It is suggested that the return of control over foreign subsidiaries had more than "some meaning."

During the discussion led by Mr. Westfall it was asserted that the practice of recording the investment in foreign subsidiaries at cost and recognizing income only upon the receipt of dividends did not provide full disclosure.⁴ Mr. Flume seems to believe that sufficient disclosure would be provided if the current assets of the foreign subsidiary were grouped together under the caption of "Deposits and Other Assets" and the

¹Ibid., p. 27.

²NAA Research Report 36, Management Accounting Problems in Foreign Operations (New York: National Association of Accountants, 1960), p. 121.

³Hecker, op. cit., pp. 26-27.

⁴Westfall, op. cit., pp. 188-189.

current liabilities as "Foreign Subsidiary Liabilities" while permitting the Fixed Assets to appear in the consolidated balance sheet.¹ It is difficult to comprehend the advantages of a mixed presentation, particularly if adequate disclosure is a salient objective. Mr. Flume argues that the various ratios which may be computed will not be contaminated as a result of his suggestions.² The validity of such ratios may be questioned even in "uncontaminated" situations.³ The question of whether more is gained as a result of the preservation of the "purity" of ratios or as a result of attempting to disclose fully the position of and results from operations of the economic entity seems to be resolved best by a selection of the latter objective.

The same writer urges the elimination of intercompany profit in inventories while recognizing the minority share of such profit by adding it to the minority interest and subtracting the same figure from the surplus of the shareholders of the parent company.⁴ He hopes that "By this entry there is a complete restoration of the legal equity of the minority stockholder."⁵ Is the restoration of the legal equity of the minority shareholders so important as to sacrifice an accurate depiction of the consolidated entity? The method of presentation thus advocated is not in harmony with the entity

¹Flume, op. cit., p. 819.

²Ibid.

³Paton and Littleton, op. cit., p. 142.

⁴Ibid., pp. 821-822.

⁵Ibid.

theory of consolidations as proposed by Mr. Moonitz and the revisions to it suggested in this paper, and is consequently rejected. The revisions advocated emphasis on administrative control as the major criterion for consolidation, with little or no reference to percentage of ownership, and elimination of the factors of homogeneity and/or integration of operations as prerequisites to consolidation.

The nagging question of adequate disclosure appears throughout the literature devoted to the problems encountered in the consolidation of foreign subsidiaries. The discussion participant who objected to the cost method of valuing subsidiary investment added his belief that proper disclosure could be provided only by the complete consolidation of wholly owned foreign subsidiaries.¹ It seems rather contradictory to be so liberal on the matter of location and so conservative about the question of ownership. In its Bulletin No. 4 the American Institute of Accountants provided several alternative presentations, representing different combinations of consolidated and separate parent and subsidiary company statements in an attempt to insure adequate disclosure.²

Recent Trends in International Investment

Referring to the postwar easing of exchange restrictions throughout the world and the increasing activity of foreign branches and subsidiary corporations of American companies one author lists the pros and cons of consolidation while admitting the lack of a stock answer to the problem.³

¹Westfall, op. cit., p. 189.

²Committee on Accounting Procedure, Accounting Research Bulletin No. 4, op. cit., p. 2.

³James A. Kelly, "Should a Corporation Consolidate Its Foreign and Domestic Accounts," New York Certified Public Accountant, (October, 1956), p. 585.

The arguments in favor of consolidation were stated as:

1. It follows, therefore, that if we try and^oare able to consolidate when the foreign net assets and results of operations are material, we should be able to work out a consolidation when they are not material.
2. A foreign-domestic consolidation is the simplest possible method of informing the reader of the total world-wide picture of the corporation.
3. A foreign-domestic consolidation removes certain problems which appear when the consolidation is not made, such as the treatment of intercompany transactions.
4. We may in the future, if foreign trade becomes more important to the total United States economy, be forced to consolidate foreign and domestic accounts.¹

Behind the reasons listed there appears to be an implied assumption that adequate disclosure is possible only through the use of consolidated statements. The need for adequate disclosure becomes increasingly urgent when attention is directed to predictions of future developments. "Almost all authorities predict a tremendous expansion of international trade and investment during the next few decades, as the presently underdeveloped countries expand their production and consumption. . . ." ² An editorial presented the opinion that the only sound basis for this growth is mutual confidence, founded on free exchange of financial information.³ A past

¹Ibid., p. 586.

²Editorial, "International Accounting," The Journal of Accountancy, (January, 1960), p. 27.

³Editorial, "Investments in Peace," The Journal of Accountancy, (November, 1959), p. 33.

president of the International Congress of Accountants expressed his concern over the fact that the accounting principles used for amalgamation purposes often differ greatly from those underlying the official annual accounts of the subsidiaries.¹ Since business combinations are also very prevalent in Europe he expressed doubt over the soundness of financial presentations.² According to the Journal editorial quoted above it is the obligation of independent accountants throughout the world to create confidence in the soundness of their reports in the belief that it will implement the flood of private investment abroad and foreign investment in this country.³ The increasing tendency to establish foreign affiliates has been mentioned before and its impact will be discussed in greater detail in a subsequent section of this report. At the present time it is appropriate to inquire whether the professional accounting organizations have provided the guidance which should be expected of them in such matters as criteria for the consolidation of foreign subsidiaries.

Applicability of Pronouncements

The current position of the American Institute of Certified Public Accountants in regard to the criteria it has established for the purpose of determining whether or not foreign subsidiaries of domestic parent corporations are to be included in the consolidated statements is found in

¹Jacob Kraayenhof, "International Challenges for Accounting," The Journal of Accountancy, (January, 1960), p. 37.

²Ibid.

³Editorial, "Investments in Peace," op. cit., p. 33.

Chapter 12 of Accounting Research Bulletin No. 43. Appropriate sections of Chapter 12 may be found on pages 37 and 38 of this thesis. The attitude of the Securities and Exchange Commission towards the subject may be found in Regulation S-X, pertinent parts of which are reproduced on page 40.

A comparison of Chapter 12 with Accounting Research Bulletin No. 4 reveals a basic similarity of approach. The extent of the likeness between the two documents is so great as to generate an inquiry about whether the hectic conditions which prevailed at the time the Bulletin was written did not provoke a response which may be unsuitable to the conditions which exist at present as outlined by the editorials and articles quoted in the prior two sections of this chapter. In view of Mr. Hecker's comments relative to the postwar return of foreign subsidiaries to the control of their American parent companies there appears to be reason to question the reasonableness of the Bulletin even at the time it was originally written. Somewhat similar observations are in order when Accounting Series Release No. 11 is compared with Rule 4-02 of Regulation S-X. The similarity of intent between the Bulletin and Release No. 11 has been commented upon and the basic agreement between Chapter 12 and Rule 4-02 is clear.

The Multinational Company

The increasing tendency to invest overseas was evident in the figures presented in Chapter I of this thesis. A recent publication estimated the total direct foreign investment for 1962 as approximately \$36 billion, an increase of \$6.3 billion per year over the figure quoted for

1959.¹ According to the same article, General Motors and Ford have invested \$2½ billion overseas since 1950, the bulk of it from earnings retained therefrom, and Eastman Kodak Company has "plowed back" more than \$100 million since 1957.² The reasons for the impetus in foreign investment are stated as increased earnings abroad as compared to domestic earnings, partly because of saturated United States' markets and increasing costs.³ The importance of its foreign operations is stressed by the president of one company.

"The net result of our investing abroad is that we have grown at both ends," says Burroughs' President Ray R. Eppert. "That's because our overseas subsidiaries serve as captive markets for the parent corporation." More than 80% of the U.S. parent's \$25 million in exports goes to its own subsidiaries, mostly as parts for fabrication but also as finished machinery. Internal sales as well as total exports have nearly doubled since 1956.

The importance of this trade is highlighted by the fact that Burroughs only breaks even on domestic sales, and gets virtually all its profits from overseas subsidiaries.⁴

Burroughs maintains foreign manufacturing operations in Canada, Scotland, France, Brazil and the Philippines.⁵ It has marketing subsidiaries in 23 foreign nations and international operations in 125 countries.⁶ Net income for 1962 of subsidiary companies in foreign countries other than Canada was \$9,468,095 and dividends paid during 1962 by these subsidiaries totaled

¹Special Report, "Multinational Companies," Business Week, (April 20, 1963), p. 64.

²Ibid., p. 64.

³Ibid., p. 64.

⁴Ibid., p. 75.

⁵Burroughs Corporation, Annual Report, 1962, p. 21.

⁶Ibid.

\$4,389,792.¹ Total income for the same year was \$9,492,588.² Return on foreign investment was 23.2%; return on total investment was 7.1%, verifying the remarks of Mr. Eppert. Burroughs does not hesitate to consolidate its operations in every corner of the globe with those of the parent company. That the situation described by Mr. Eppert may not exist solely in the experience of Burroughs is evidenced in another article wherein it is claimed that during 1955 total foreign dividends and profit remittances exceeded foreign investment by \$600,000.³ The fact that this occurred eight years ago coupled with the accelerated movement of capital overseas suggests continued profitability.

Until recently⁴ the provisions of the Internal Revenue Code provided additional incentive for foreign investment. "So-called 'haven countries,' i.e., countries with a very low rate of tax or which impose no tax on income from operations arising outside the country, have been used by certain United States corporations trading overseas as a means of avoiding or delaying the 52 per cent United States tax on foreign earnings by setting up subsidiaries in such countries."⁵ Because income earned overseas was not subject to tax until repatriated to the United States one

¹Ibid., p. 18.

²Ibid., p. 15.

³Kelly, op. cit., p. 586.

⁴The possible effect of pertinent provisions of the Revenue Act of 1962 enacted in October, 1962, will be discussed subsequently.

⁵Alexander Cameron, "Tax Considerations in Organizing a Business Abroad," The Journal of Accountancy, (July, 1958), p. 49.

use of the "haven" corporation was the establishment of branch or subsidiary operations in other "low-tax" foreign countries, thus reinvesting the resulting profits in overseas business without depleting the funds of the American parent corporation.¹ Moreover, the total income tax on a foreign subsidiary was frequently less than the tax on a comparable domestic company. Income of \$100 earned at home and taxed at the corporate rate yielded tax revenue of \$52. The same amount of income earned abroad, if taxed at a rate of 30 per cent, would have been reduced by taxes of \$30. When remitted to the American parent company the remaining \$70 taxed at 52 per cent resulted in a tax of \$36.40. However, a credit of the \$70 multiplied by the foreign tax rate of 30 per cent was permitted against the United States tax of \$36.40 resulting in a domestic tax of \$15.40. Total foreign and United States taxes were \$45.40, as compared to \$52.00 for the domestic counterpart. According to Mr. Cameron, the optimum advantage was secured if the foreign rate was 26 per cent, assuming the United States rate remained at 52 per cent.²

For these and other reasons the truly multinational company has emerged. "It has a genuinely global perspective; its management makes fundamental decisions on marketing, production, and research in terms of the alternatives that are available to it anywhere in the world."³ For such

¹Ibid., p. 49.

²Ibid.

³"Multinational Companies," op. cit., p. 63.

a corporation, the United States is but one of many markets, one of many sites for production or research."¹ The modern industrial corporation is fast becoming an institution that is transcending national boundaries. For example, Deere & Company with subsidiaries in nine foreign nations has recently integrated its domestic and foreign operations by assigning worldwide responsibilities to its vice presidents for manufacturing, marketing, finance and research.² Under these circumstances it is indeed difficult for the corporation to support the consolidation policies stated in Note 1 on page 42 of this thesis.

The question of consolidation of a subsidiary with a parent which owns less than 50 per cent of its voting stock has been answered in the affirmative in this paper, if administrative control is present. It is worth while to note that President Edgar F. Kaiser of Kaiser Industries Corporation not only recognizes this possibility, but advocates minority ownership of foreign subsidiaries because "it helps avoid the stigma sometimes associated with being a 'foreign company'" and "It's also good business insurance to share ownership with a number of small local investors whose return from their investment will seep through the local economy."³ Other company officials have even suggested that eventually the stock of the American parent company should be widely held in nations where the

¹Ibid., p. 64.

²Ibid., p. 75.

³Ibid., p. 84.

company owns an interest in subsidiary companies.¹

Possible Objections to Consolidation of Foreign Subsidiaries and Rebuttal

A theorist summarizes the reasons which may be advanced for the failure to include foreign subsidiaries in the consolidated statements of the parent company and its subsidiary companies.

In the first place, it is not uncommon for foreign governments to impose legal regulations requiring a certain per cent of the voting shares of every company incorporated in that country to be held by nationals of the particular country. . . . Another similar regulatory measure may involve the requirement that a specified number of the members of the board of directors of the foreign corporation be nationals of the country of incorporation, regardless of the ownership of voting shares.

The second type of restriction: which must be considered in reaching a decision as to the existence of effective control over a foreign subsidiary at a particular time, and hence, as to the propriety of including the accounts of the subsidiary in consolidated statements, relates to restrictions on the convertibility of the foreign currency for the purpose of obtaining dollars to remit to the American parent corporation.

The third type of restriction which may be imposed by a foreign government with a resulting effect on the freedom of control which the parent corporation might otherwise exercise, relates to restrictions on international transactions at the real rather than the financial level.²

Fear over restrictions in currency convertibility has been one of the primary reasons advanced by the regulatory agencies as a suitable

¹Ibid., p. 86.

²Hepworth, op. cit., pp. 162, 163 and 166.

motive for not consolidating foreign subsidiaries. There are several methods of restricting the transfer of funds between countries. The most widely encountered devices are:

Limitations on the amount of current earnings which may be withdrawn; discrimination as between the country to which earnings may be paid; approval or disapproval of each application for exchange for this purpose based on the merits of the particular case; the making of special arrangements or "deals" with particular American corporations; or outright prohibition on the withdrawal of earnings under any circumstances.¹

One writer places the fears regarding jeopardy of investment into perspective by pointing out that it is unlikely that a corporation would acquire or establish a foreign subsidiary in a nation which had enacted laws preventing control.² Of course, the possibility of subsequent enactment of restrictions exists. This necessitates a continuing examination of foreign business regulations. It should always be borne in mind that laws are not necessarily enforced. In reference to the first type of restriction, it has been pointed out that the effect of such requirements on control depends upon the identity of the holders of the required number of shares. If their attitude is cooperative toward the American parent company the law counts for little.³ The same observation may be made in situations where the statute applies to board membership rather than to stock ownership.

¹Ibid., p. 164.

²Moonitz, The Entity Theory of Consolidations, op. cit., pp. 32-33.

³Hepworth, op. cit., p. 162.

Mr. Kaiser's remarks are worth recalling at this point, as evidence that even in these cases where the law is enforced there need not be fear of loss of administrative control.

Currency Conversion Restrictions.--Restrictions on the freedom to transfer funds from the foreign country in which a subsidiary is located to the United States are generally feared more than other types of restrictive legislation. Since restrictions of this type usually apply to dividends, loss of the ability to repatriate funds in this form is ordinarily considered to be sufficient reason not to consolidate foreign subsidiaries, although the formal reason given is often "Geographic Location" or there is no reason at all.¹ However, restrictions on other types of transfers are frequently viewed with as much trepidation. Ultimately, the question of whether loss of the right to transfer monies justifies the conclusion that consolidation is not appropriate must be considered. However, there is the more pragmatic issue of the existence or lack of existence of such restrictive measures.

According to the article which appeared in Business Week, estimated total sales by United States owned plants abroad during 1962 were \$27 billion.² Slightly less than 42 per cent of this figure was accounted for by American affiliates in Western Europe, a little less than 35 per cent by Canadian branches and subsidiaries, over 15 per cent by Latin American associates and the remainder by American owned branches and subsidiaries in other parts of

¹See page 41.

²Multinational Companies, op. cit., p. 64.

³Ibid.

the world.¹ It seems fair to presume that the volume of direct investment abroad is somewhat correlated with the sales figures presented. It is also probably true that a large portion of sales and investment in each area took place either in highly industrialized nations or in underdeveloped countries which possessed substantial quantities of exploitable natural resources. Accordingly, a fair sample of Western European nations might include France, Western Germany, Italy, the Netherlands, Portugal, Spain, Switzerland and the United Kingdom. Argentina, Brazil, Mexico and Venezuela are Latin American nations which have probably attracted a major share of American investment in that area of the world. In the Middle East, Aden and Iran may be representative nations and in the Orient, Australia, Japan and The Philippines deserve consideration.

At the end of 1962, Canada had no restrictions on the transfer of local funds into United States dollars through dividends and no restrictions on the settlement of United States dollar obligations existing between United States parent companies and their Canadian subsidiaries.² Western Germany, The Netherlands, Spain and Switzerland had no restrictions on dividend and capital payments.³ In Australia, France, Portugal and the United Kingdom it was necessary usually to secure approval but approval was ordinarily granted automatically.⁴

¹Ibid.

²Price, Waterhouse & Co., Information Guide for Those Doing Business Outside the United States of America - Current Foreign Exchange Information (1963), p. 10.

³Ibid., pp. 17, 25, 33, and 35.

⁴Ibid., pp. 5, 16, 30 and 38.

Profits of wholly owned Italian subsidiaries were freely transferred, if the enterprise was "productive." If "non-productive," free transfer was permitted up to an amount not exceeding 8 per cent of the capital invested. Excess profits could have been used in Italy for specified purposes or transferred abroad at a free market rate. The Italians define "productive" generally in connection with the provision of goods and services. It was possible to settle other dollar obligations between Italian subsidiaries and their United States parents with permission, which was not normally withheld.¹

Argentina and Mexico possessed no restrictions on currency movements, although Argentina levied taxes on certain imports and exports.² Brazil limited yearly dividends to 10 per cent of "registered" capital and capital, itself, could have been repatriated at the rate of 20 per cent per year.³ There were other regulations pertaining to specific transactions and certain overall limitations placed into effect by the Brazilian government. It was possible to remit from Venezuela with few obstructions but the exchange rate was usually specified.⁴

It was necessary to secure permission in Aden, but it was normally granted.⁵ Iran levied no restrictions.⁶

¹Ibid., p. 21.

²Ibid., p. 4.

³Ibid., p. 9.

⁴Ibid., p. 39.

⁵Ibid., p. 4.

⁶Ibid., p. 20.

The Philippines did not restrict remittances.¹ Japan imposed restrictions which could have been avoided by compliance with certain requirements; primary among them was licensing by the government.²

According to the laws of the countries selected, interference in the process of transmission of funds from subsidiaries located therein to parent corporations located in the United States had slight validity as an excuse for not consolidating the companies, as of December 31, 1962. This may not have been the situation in prior years and it may not continue to be so. Moreover, although the presumption that most overseas investments occurred in the countries selected is probably fair, the laws of the countries not selected may be more stringent. The two exceptions notwithstanding, it is hardly possible not to view the reason of "restrictions on currency conversion" often presented as justification for unconsolidated foreign subsidiaries, without skepticism. These comments apply not only to dividend remittances, but for the most part, to other remittances as well.

If restrictions are in effect, there are alternative methods of getting money out of most foreign nations. For example, a large American manufacturer forces its overseas subsidiaries to pay more than is necessary for parts imported from it and other subsidiaries. The policy is justified by one of the parent company's executives who says, "We do this in countries where we either anticipate or already face restrictions on profit repatriation."³

¹Ibid., p. 30.

²Ibid., p. 22.

³Multinational Companies, op. cit., p. 80.

Profits may be repatriated through the device of payments on loans made by the parent, particularly in situations involving the establishment of new subsidiaries. The parent may capitalize the subsidiary in a nominal amount and lend it the balance of the funds needed to get it under way.¹ The interest rate charged may be excessive in comparison to the rate normally charged. An alternative measure which serves to limit the risk taken by the parent company is the practice of borrowing in the country in which the subsidiary is located.² If it becomes impossible to withdraw funds, payments on the debt may be stopped. The principal objection to borrowing abroad is the high interest rates in force in most countries.

Assuming that these and other methods of coping with restrictions on fund movements are blocked there exists the possibility of dealing in commodities. An example is provided by one writer.

Assuming no commodity export-import prohibitions other than customary tariff barriers, however, a foreign subsidiary engaged in an extractive industry, processing basic raw materials, or manufacturing may easily continue to operate as an integral part of a far-flung international holding company empire. In such a case, the American parent would finance foreign operations and be reimbursed by bringing out of the foreign country the ores, metals, or manufactured products to be used or sold elsewhere. In a similar manner revenues from foreign sales could be recovered by purchasing raw or finished materials abroad and using them in other phases of a combination's operations.³

¹Cameron, op. cit., p. 17.

²Ibid.

³Moonitz, The Entity Theory of Consolidations, op. cit., p. 33.

For these and other similar reasons, one author concludes:

The existence of restrictions which limit or abolish the right of a parent company to initiate the declaration and payment of dividends is certainly not necessarily adequate evidence to justify the conclusion that the control typically associated with majority stock ownership is impaired to a degree justifying exclusion from consolidation.¹

The present writer would qualify this observation by eliminating the requirement of majority stock ownership as a condition necessary for consolidation.

Mr. Hepworth continues by writing:

It appears logically necessary to conclude that restrictions on international capital movements should not be considered as impairing the control exercisable by the parent corporation over subsidiary operations. . . .²

Mr. Moonitz summarizes the arguments against the use of restrictions on convertibility as a justification for not consolidating foreign subsidiaries by observing that the existence of restrictions on a financial level for the purpose of forcing transactions through officially designated channels or implementing a phase of monetary policy does not destroy unity of operations.³

Restrictions of this general type are found in the United States as well as overseas. Here they often are imposed by contract; there they are usually imposed by governmental decree. Restrictions on the payment of dividends in deference to a bond indenture are fundamentally no different than

¹Hepworth, op. cit., p.166.

²Ibid., p. 163.

³Moonitz, The Entity Theory of Consolidations, op. cit., p. 33.

such restrictions in deference to a law limiting the amount of dividends payable to a foreign parent company, such as exists in Brazil. Neither should normally be considered severe enough to warrant excluding the subsidiary from consolidation.

The imposition of commodity restrictions, particularly if they are in conjunction with currency restrictions, has moved Mr. Hepworth close to a decision not to consolidate.

More specifically the reference at this point is to restrictions on the transfer of commodities such as import or export quotas or prohibitions. Where restrictions of this type exist, particularly where they accompany currency restrictions, the effect on the continued existence of effective control by the American parent corporation is likely to be much more severe than in the case of currency restrictions alone. Resort to commodity remittances to the parent company in lieu of the payment of cash dividends may no longer be available as an escape from the fetters of restricted currency convertibility. Although it is again essential to evaluate the circumstances in a particular case, the resulting conclusion may very likely be that control is actually impaired, with the result that the criteria appropriately applied to the problem of consolidation are no longer adequately fulfilled.¹

Even if severe commodity and currency restrictions exist at the same time there may still be justification for consolidating the subsidiary located in the country of imposition with its American parent. The reason may be found in the attitude of the American parent company. "A multinational company's interests should outlive temporary political reversals; no company that considers itself multinational will readily give up a big potential market."² That this happens in practice as well as theory is attested to in

¹Hepworth, op. cit., p. 167.

²Multinational Companies, op. cit., p. 80.

two instances. At least half of their earnings are reinvested by Texas Instruments, Inc., in its overseas subsidiaries.¹ It does this even in Argentina, where business is bad and probably will remain bad for some time, because in the words of its senior vice president, "we want to keep our Argentine company alive."² The same executive, Mr. Harris, reveals that there are other reasons for maintaining an interest in foreign subsidiaries, in spite of certain seemingly adverse circumstances. He comments on the practice of playing the international money markets by transferring funds between countries. "We believe in working the hell out of our money. It's a side benefit of overseas operations, but it's foolish to ignore it."³ Brazilian political conditions are volatile and the restrictions described in this chapter exist but another American company is not discouraged because "Brazil is for us the biggest Western Hemisphere market outside the United States."⁴ The vice president of the company continues by saying, "We intend to hang on, and meantime we can count on our operations in 12 other countries."⁵

The Brazilian government has expropriated the properties of certain companies. The American and Foreign Power Company, Inc. was affected by a

¹Ibid.

²Ibid.

³Ibid., p. 84.

⁴Ibid., p. 80.

⁵Ibid., pp. 80-82.

Brazilian decision to seize the properties of various foreign public utility companies. However, an understanding was reached on April 22, 1963, between the company and the Brazilian Government on the terms to be incorporated in a subsequent contract of sale pursuant to which the company's interests in all of its utility subsidiaries in Brazil would be purchased by the Brazilian Government or one of its agencies for a price of \$135,000,000.¹ The company has ten utility subsidiaries in Brazil in which its direct and indirect investment at June 30, 1963, was \$150,000,000 approximately.² Therefore, even in cases of outright seizure the investment in the foreign subsidiary may not be entirely lost.

The company has sold other foreign subsidiaries in Colombia, Costa Rica and Mexico and has diversified its operations as indicated by the magnitude of its non-utility income of \$5,296,000 out of total income of \$10,570,188 for the six months ended June 30, 1963.³ To this end, Foreign Power is actively pursuing its industrial acquisition program outside the utility field in Argentina and Mexico.⁴ This indicates its lack of discouragement over the reverses it has suffered and its confidence in a promising future for foreign investment.

¹American and Foreign Power Company, Inc., Financial Report (June 30, 1963), p. 8.

²Ibid. p. 8.

³Ibid., pp. 2 and 6.

⁴Ibid., p. 4.

It is well to remember that there are means of mitigating the effect of many laws, even in our own country, and the possibility of the existence of special arrangements between the American parent company and the government of the foreign country in which its subsidiary is located is an added factor which should lessen the reliability of conclusions based upon a knowledge of the formally established regulations relating to exchange and other controls. Even in extreme cases of international calamity the long range point of view needs to be maintained. The onset of World War II generated panic in the minds of business men and professional accountants, as well, as evidenced by the literature of the times. However, as Mr. Hecker has indicated, the panic need not have been as severe as it was.¹ But if the hysteria of the day was pardonable, its continued effect on the attitudes of the commercial community was not. The world changed greatly and quickly, shortly after the end of the war. It is unfortunate that professional accountants, in particular, have been slow to adjust to the changes that occurred. However, the conservative attitude resulted in a degree of limited vision even before the calamitous events of the nineteen forties, particularly in regard to the consolidation of foreign subsidiaries. It is hoped that a less rigid and more realistic point of view will prevail in the future and that the developments anticipated by Mr. Kraayenhof and others, as stated on pages 133 and 134 of this thesis, will be accelerated.

¹See page 129.

Recent Trends in Consolidation of Foreign Subsidiaries

Referring to the accelerated trend towards the inclusion of the accounts of foreign subsidiaries in the consolidated statements of the business entity one article submits the following major reason for the movement: an improvement in the economy of much of the free world, particularly in the United Kingdom and on the Continent.¹ This has resulted in greater fiscal responsibility on the part of the nations involved, increased corporate earnings and relaxed currency restrictions.²

In the same article thirty eight companies which recently decided to consolidate some or all of their foreign subsidiary companies were listed. The following companies now consolidate all foreign subsidiaries.³

COMPANY	SUBSIDIARIES CONSOLIDATED	YEAR CONSOLIDATED	FOREIGN SALES AS % OF TOTAL SALES
Atlas Powder	All foreign	1958	N.A.
Colgate-Palmolive	All foreign	1957	49%
Conde Nast	All foreign (Canadian previously consolidated)	1958	N.A.
Dow Chemical	All foreign (Canadian previously consolidated)	1956	10%+

¹Anna Merjos, "Merging Accounts," Barrons (February 15, 1960, p. 5.

²Ibid.

³Ibid.

COMPANY	SUBSIDIARIES CONSOLIDATED	YEAR CONSOLIDATED	FOREIGN SALES AS % OF TOTAL SALES
Gillette	All subsidiaries	1953	53%+ *
International Packers	All foreign subsidiaries	1958	84%
Libby, McNeill & Libby	All foreign (Canadian consolidated previously)	1955	30% est.
Merck	All foreign	1956	27%
Minneapolis-Honeywell	All foreign (Canadian previously consolidated)	1955	N.A.
Schering	All foreign	1957	21%
Socony Mobil	All foreign (Eastern Hemisphere subsidiaries not consolidated previously)	1956	60% *
Timken Roller Bearing	All foreign	1958	13%
Underwood	All foreign	1958	28%
Warner-Lambert	All subsidiaries (Companies operating in Europe, Argentina, Brazil not previously consolidated)	1958	24%
Westinghouse Electric	All foreign	1957	8%
Worthington	All foreign	1959	15%

+ Excludes Canadian operations

* Foreign earnings as % of 1958 net income

N.A. Not available

A glance at the final column in the exhibit reveals a possible major impetus of the trend. Large foreign sales do not necessarily result in large foreign profits. However, the implication is clear in the cases of the Gillette and Socony Mobil companies. The author of the article further states that for Colgate-Palmolive "earnings outside the United States are believed to represent no less than two-thirds of the overall net."¹

Obviously, in such cases consolidation presents a much more formidable picture of earning power. Furthermore, it gives the stockholders a clearer conception of the growth of the business, of the financial resources supporting their equity and of the potential of the consolidated equity. "A case in point is Conde-Nast, which reported a loss for 1958 of \$535,000 For that year, in contrast to the parent, the foreign subsidiaries netted over \$200,000."²

Since the date of the article, many other American companies have decided to consolidate their foreign subsidiaries. Among them is the Minnesota Mining and Manufacturing Company which first presented consolidated statements of the parent company and all its subsidiaries in 1959. In that year consolidated net income was \$63,564,729 as compared to \$60,262,440 under the former approach of consolidating only domestic and Canadian companies.³ Net sales increased over 12% from \$446,580,323 according to the old basis,

¹Ibid.

²Ibid., p. 6.

³Minnesota Mining and Manufacturing Company and Subsidiaries, Financial Report, (December 31, 1959), p. 14.

and net working capital increased \$9,171,797 as a result of the decision to consolidate foreign operations. It is evident from this brief example that the statements prepared for the entire business entity reveal the affairs of that entity more thoroughly than do statements of a part of the entity.

Another case in point is the United Shoe Machinery Corporation which decided to consolidate "all associated companies throughout the world in which the parent Corporation has more than a 50% ownership."¹ According to Mr. William Dykstra, Assistant Controller of the Corporation, the decision was made in order "to give our stockholders a more complete picture of our over-all operations." When pressed for further details Mr. Dykstra commented, "Our foreign operations grew after the war and became increasingly important." He declined to elaborate.

Since 1899 when shoe machinery companies were organized in England and Canada the company has expanded its overseas organization until it now owns companies in 20 countries throughout the British Commonwealth, Continental Europe and Latin America.² At the close of the last fiscal year 15,121 employees of a total of 21,764 were employed by foreign associated companies.³ The net effect of its foreign operations on the overall showing of the entity may be more fully appreciated by referring to the following summary.⁴

¹United Shoe Machinery Corporation, 1963 Annual Report, (February 28, 1963), p. 3.

²Ibid., p. 12.

³Ibid., p. 19.

⁴Ibid., p. 2.

**UNITED SHOE MACHINERY CORPORATION
AND ASSOCIATED COMPANIES CONSOLIDATED**

Highlights	All Companies		Domestic Only	
	For Year Ended	February 28 1963	February 28 1962	February 28 1963
Gross Operating Income.		\$198,031,534	\$197,341,667	\$95,424,411
Included in the figures are domestic sales of shoe machines outstanding under lease, amounting to \$2,654,273 for 1963 and \$3,750,194 for 1962.				
Dividends from Foreign Associated Companies.				\$ 3,467,025
Income before Income Taxes. . . .		\$ 21,656,446	\$ 24,020,305	\$10,231,129
Net Income for the Year		\$ 10,815,063	\$ 11,543,051	\$ 7,461,406
Dividends Paid on Preferred Stock Per Share.		\$ 301,534 \$1.50	\$ 301,534 \$1.50	\$ 301,534 \$1.50
Net Income Applicable to Common Stock.		\$ 10,513,529	\$ 11,241,516	\$ 7,159,872
Per Share of Common Stock. . . .		\$4.52	\$4.84	\$3.08
Included in the figures are domestic gains resulting from sales of shoe machines outstanding under lease, after allowing for U.S. income tax at the 52% ordinary corporate rate, amounting to \$899,337 for 1963, equivalent to \$0.39 per share and \$1,624,285 equivalent to \$0.70 per share for 1962.				
Dividends Paid on Common Stock. .		\$ 5,811,043	\$ 6,386,807	\$ 5,811,043
Per Share.		\$2.50	\$2.75	\$2.50
The figures for 1962 include a special dividend of \$0.25 per share paid May 1, 1961 amounting to \$580,224.				
Earnings for the Year Retained in the Business		\$ 4,702,486	\$ 5,434,933	\$ 1,348,829

For the fiscal year ended February 28, 1962 the parent Corporation and its domestic subsidiaries earned \$7,987,737 net income.

The confidence of the company in the future of its foreign operations is evidenced by the following remarks.

Continued emphasis was given during 1962 to the organizational structure of the Corporation's international operations with the establishment of the United Shoe Machinery Corporation (International) in Lausanne, Switzerland, to coordinate and expand the activities of the associated companies in the Continental European Region.¹

From the examples presented above it is logical to conclude that the consolidation of the accounts of foreign subsidiaries with those of the parent company may result in an entirely different interpretation of the present position of the entity and the results of its operations for the period then ended than a presentation of the same figures for the parent alone or the parent and its domestic subsidiaries, even if the parent records its share of subsidiary profits in its accounts. Moreover, an accurate prognosis of future trends is virtually impossible without consideration of the effects of foreign operations. Since the restrictions so greatly feared to not seem to exist, or to exist in a much diluted form there seems to be little reason for not taking advantage of the increased possibilities to acquire more accurate information about the business through the process of consolidation of foreign subsidiaries.

¹Ibid., p. 14.

Possible Effects of Changes in
Internal Revenue Code

The Revenue Act of 1962, HR 10650, was signed by the President on October 16, 1962.¹ Among other changes in the tax structure incorporated in the new act were provisions relating to taxation of income from foreign investments.² The possible impact of the legislation may be appreciated when it is understood that the new law permits the federal government to tax the profits of foreign subsidiaries before they are repatriated as dividends to the United States, for the first time in history.³ This privilege and other features of the proposed law prompted the AICPA Committee on Federal Taxation to submit the following and other comments to the Senate Finance Committee on June 26, 1962.⁴

1. Foreign commerce will be discouraged and United States exports reduced.
2. Entirely new and unwise concepts are proposed by disregarding the separate entity of foreign subsidiaries.
3. United States business would be hampered in competition with other countries' nationals in markets foreign to both.

¹News Report, Taxation, "President Signs Revenue Bill After Final Congressional Passage," Journal of Accountancy, (November, 1962), p. 28.

²Ibid.

³Government, "U.S. Taxes Reach Across the Sea," Business Week, (November, 1962), p. 71.

⁴Statements in Quotes, "Comments on Amendments to the Tax Bill (HR 10650) Proposed by the Treasury Department," Journal of Accountancy, (August, 1962), pp. 60-65.

4. Arbitrary distinctions between developed and underdeveloped countries will discourage American business investments abroad.
5. The spirit and interest of twenty-one bilateral tax conventions would be violated.¹

The significance of the law may be segregated into two parts. First, it ignores the corporate entity and imputes to the United States shareholder income earned by a presumed "controlled" corporation. Second, it attempts to curtail the abuses perpetrated by corporations with subsidiaries located in "tax haven" countries. Although adoption of the first principle is discriminatory since it is not generally applicable to all corporations, it does indicate to some degree the position of the federal government in regard to recognition of the economic entity, a position which both the courts and the accounting profession have been reluctant to accept. Moreover, the action seems to indicate that Washington is not as concerned about "restrictive legislation" and "unsettled conditions" overseas as are most accounting theorists, professional organizations and some businessmen.

Although it is true that the provisions of the law relating to the recognition of foreign income were much closer to the AICPA Committee's recommendations than the original version criticized by it,² there is reason to doubt that the Committee's basic position was substantially altered by the changes.

¹Ibid., p. 64.

²News Report, Taxation, op. cit., p. 28.

Possibly the most reliable evidence as to the effect of the law on United States investment overseas can be expected to come from the executives of companies with subsidiaries located in foreign countries. In this connection, attention should be focused on the "escape hatches" provided in the law. Among them is the omission of sales income of manufacturing subsidiaries, for the most part.¹ Relief is provided for foreign subsidiaries that qualify as "export trade corporations."² Foreign subsidiaries in less-developed countries can re-invest earnings in the country in which the earnings originate.³ Also, subsidiaries in advanced nations are permitted to exclude from United States taxable income dividends they receive from companies in less developed countries, if they do not exceed the latter's increase in assets for the year.⁴ The "minimum distribution" clause says, in effect, that if a subsidiary pays a certain amount of dividends to its United States parent company each year, the rest of the subsidiary's tax-haven income can be excluded from immediate United States tax.⁵

It seems fair to conclude that like most other tax measures, HR 10650 not only had "escape hatches" at its inception but also its

¹Government, "U.S. Taxes Reach Across the Sea," op. cit., p. 74.

²Ibid.

³Ibid.

⁴Ibid.

⁵Ibid.

built-in "loopholes" which will be discovered subsequently. The business community has begun to react accordingly. For example:

A major chemical producer with several plants in Europe selling through a centralized Swiss sales company is planning to revert to sales by each manufacturing subsidiary.¹

A United States machinery manufacturer with rapidly expanding overseas operations is considering several moves. It may split its own worldwide organization into two main parts, one operating in developed areas and the other in underdeveloped areas of the world.²

More subtly, this company is getting ready to reduce investments in a number of its overseas operating units before year-end--and particularly in less developed countries. That is because the amount of income excludable from United States taxation in some cases will be tied to increases in assets after January 1.³

Finally, this company is looking closely at the losses some of its newer units have built up. In its reorganization it hopes to channel through these units some of the income that will now be taxable. Reason: Any losses incurred since the end of 1959 can be used to offset the newly taxable income.⁴

If the above reactions are typical, American business has not been discouraged sufficiently to substantially reduce its overseas investments but, rather, is simply adjusting to the new regulations, which is its typical solution of problems of this nature. It is believed it will

¹Ibid., p. 71.

²Ibid., p. 72.

³Ibid.

⁴Ibid.

continue to do so until the adjustment proves to be more costly than the benefits derived from the process. The business community has proven to be very adept at the art of survival in the face of so-called adverse circumstances and, therefore, there is reason to believe that this talent is sufficiently developed to serve the same purpose in the future. Moreover, the possibility of an increase in Federal Income Tax payments as a result of the consolidation of foreign subsidiaries is somewhat lessened since the foreign profits may be taxed anyhow. Therefore, there is less justification for not consolidating.

Technical Difficulties in Accounting
For Foreign Operations

N.A.A. Research Report 36 states that the principal problems in accounting for foreign operations result from the fact that accounts are expressed in different currencies.¹ This is not a reference to currency restrictions but rather, as one author explains, to the problems associated with the conversion of the monetary units in which the data are recorded into dollars.² He continues by saying that quoted exchange rates are in some cases highly artificial as well as variable.³ Another writer asserts that control of a foreign subsidiary may be nominal rather than actual if there is no effective rate of exchange.⁴ Mr. Kohler lists as one possible reason for the exclusion of a foreign subsidiary from consolidated statements,

¹N.A.A. Research Report 36, op. cit., p. 2.

²Paton and Paton, op. cit., p. 579.

³Ibid.

⁴Lewis, op. cit., p. 227.

a widely fluctuating rate of exchange.¹ An additional reason for the dismay expressed over the problems of conversion of foreign currencies into the domestic currency of the parent company is the assumption that equivalence exists between account balances stated in local currency and the same balances translated into dollars.² "However, common experience indicates that relative price levels in the United States and other countries do not correspond closely to rates of exchange between the currencies."³ Mr. Moonitz comments on this subject.

Inability to reconcile the conflicting demands of two currencies subject to erratic and uncorrelated fluctuations may necessitate the abandonment of consolidation of accounts. This step should be taken, however, only as a last resort after all possibilities of reconciliation through explanatory notes and other devices have been exhausted.⁴

Differences in domestic and foreign accounting practices may occasion some difficulty in the preparation of consolidated statements. The principal differences as reported in one publication are as follows:

1. Official recognition of currency inflation and the upward reevaluation of fixed assets in some countries.....
2. Greater conservatism as reflected in more rapid depreciation.....
3. Use of reserves to equalize profits from year to year.⁵

1. Kohler, "Some Tentative Propositions Underlying Consolidated Reports," op. cit., p. 65.

2 N.A.A. Research Report 36, op. cit., p. 24.

3 Ibid.

4 Moonitz, The Entity Theory of Consolidated Statements, op. cit., p. 35.

5 N.A.A. Report, op. cit., p. 7.

The same source points out that when these differences are material, the financial statements of the foreign subsidiaries may be adjusted to reflect the same accounting conventions followed by the United States parent company before the statements are consolidated.¹

Technical difficulties are not conceived of as major deterrents to the process of consolidation. Indeed, their nature precludes their inclusion in a discussion of the theory of consolidation. They are regarded as matters which have a solution in all cases. It is admitted that the solution may be difficult to achieve in certain situations but this does not change the basic nature of the problem.

Conclusions

It is hardly necessary to state the conclusions reached in this chapter at this point because they appear at various places in the chapter. Two implied observations appear to require specific enunciation, however. First, if the comments of the businessmen quoted in the next to the last, and its two preceding sections are accepted as indicative of a general attitude, Mr. Hepworth's nearly limiting situation of combined commodity and currency restrictions may be too drastic. It seems as though a long range point of view is better suited to the task of arriving at decisions regarding the advisability of consolidation than the somewhat short range posture assumed by Mr. Hepworth. However, the author feels constrained to caution against the exercise of too much optimism in regard to these matters, just as he opposed the extreme pessimism which prevailed during World War II and its postwar continuance.

¹Ibid.

As a final comment, it is suggested that in all cases the burden of proof logically falls on those advocating exclusion of a foreign subsidiary's accounts from consolidation. In addition, it should be recognized that each situation is unique and requires a solution predicated upon its individual characteristics. This, in turn, demands the abolition of the somewhat rigid rules that have prevailed in the past and are still in existence.

CHAPTER X

SUMMARY AND CONCLUSIONS

The objective of this thesis was the development of criteria to be used in the formulation of decisions regarding the consolidation of foreign subsidiary corporations. However, a condition precedent to this objective was the development of criteria applicable to the consolidation of all subsidiaries, domestic and foreign. The requirements for the general case must apply to the special case, as well, although they may be supplemented to cope with the unusual circumstances which may accompany the exceptional situation.

It was considered necessary to review the criteria in existence. This was done for the purpose of acquiring the familiarity necessary to assure a logical analysis of the theoretical adequacy of the existing requirements. It was decided that the effectiveness of the existing regulations should be evaluated. Accordingly, current consolidating practices were considered.

Because any discussion of the validity of theory inevitably culminates in the question of its applicability to the problems of real life situations an understanding of those problems is necessary. Consequently, chapter two began with a discussion of basic issues. Not all issues referred to were deemed to be of equal importance, but each had its place in over-all discussion if not because of its direct significance, because of its corollary implications. For example, the major issue discussed in the second section

of the chapter involved a consideration of the criteria governing decisions about whether or not consolidation was proper in a given situation. The other issues mentioned revealed concern over the problems associated with the non-consolidation of subsidiary corporations and immediately raised the question of whether these issues should exist at all. If the criteria are explicit and adhered to there is doubt about the need for a discussion of alternatives to consolidation.

An examination of the pronouncements of three professional organizations revealed general agreement about the circumstances under which it is considered advisable to consolidate the accounts of a parent company and its subsidiaries. It also revealed a tendency to permit individual judgement to prevail in most situations. Hence, the official releases may be criticised on the grounds of providing little guidance to practitioners.

An analysis of current practice confirmed the diagnosis of the effectiveness of the publications referred to. There was little uniformity in policies regarding the preparation of consolidated statements including only domestic subsidiary companies. The decision to do so or not often turned on the questions of majority ownership of voting shares and homogeneity of operations. These points were not generally stated as requirements by the professional bodies but merely as indications that other requirements had been fulfilled.

The problems associated with the consolidation of foreign subsidiaries were considered in chapter three. The possibility of restrictions

on the movement of funds between companies has had considerable influence upon the attitude expressed in official statements about the consolidation of foreign subsidiaries. Various suggestions were made about methods of presentation in the event such restrictions exist. Several alternatives were made available and selection is a matter of personal preference. The net result was the creation of an additional exception to the rules of thumb of majority ownership and homogeneity of operations. It was usually expressed as "geographic location" or "all excluded." In general, there was less uniformity of policy in this area than in the case of the consolidation of domestic subsidiaries. The weight given to the so-called special circumstances attendant upon overseas investment appeared to be disproportionate.

As a result of the above described situations an investigation of theory was undertaken. To insure consistency, the inquiry originated with a discussion of the least complicated form of business entity, the individual corporation. It then proceeded into corporate combinations of various kinds. Consolidation or merger of several corporations was investigated earlier than the parent-subsidiary relationship because of their culmination in a single corporate body. Nevertheless, they are a step in the progression to the more complicated situation of the control of one corporation by another. Since all are forms of the business entity, it was surmised that conclusions about one should apply to all with equal force.

For purposes of proper orientation, it was reasoned that the economic function of the business entity in a democratic society should be

used as the springboard to further conclusions about the entity's determining characteristics. Hence, chapter four began with a statement regarding the allocative function of this form of institution. The necessity for proper identification as part of the effort to communicate information regarding the efficiency of business organizations to interested parties was stressed.

In general terms, the remainder of the chapter was devoted to a review of four basic concepts of the corporate organization. The four concepts discussed were the proprietary, entity, social institution and legal theories. From these four, selection of the one idea most suitable to the economic facts of life was necessary. Because of its lack of acceptance by the accounting profession the so-called legal concept of the corporation was immediately discarded. The entity and proprietary theories were more seriously considered on the grounds of widespread acceptance of both by the business community and accounting practitioners, as well. It was recognized that the two theories do not have a common meeting ground and, hence, selection of one over the other was imperative for the development of a set of accounting principles applicable to all forms of business organization.

By definition, the entity theory applies only to the corporate form of business organization. Moreover, a strict interpretation of the idea leaves no room for the concept of an economic entity resulting from the amalgamation of several separate corporate bodies through the medium of administrative control. This was interpreted as being contrary to economic reality. In addition, the entity concept results in accounting practices which are conflicting at best. Finally, its roots are found in legal

technicalities which were never meant to be the source of a theory of accounting and among which there is no basic agreement.

In contrast, the proprietary theory may be applied to all forms of business organization. Its acceptance facilitates the adoption of the concept of an economic entity composed not only of the parent corporation and its subsidiary corporations but also of the parent corporation and subsidiary partnerships, as well. It may also be used to support the contention that an economic entity may exist without the presence of a parent corporation. However, this paper is not concerned with the application of the idea of economic oneness beyond the parent-subsidiary stage. Use of the proprietary theory also permits the development of accounting principles which are coherent with the theory and with each other. Accounting practices derived therefrom may be justified more easily than those derived under the entity theory. Hence, the proprietary theory of the business organization was accepted to the exclusion of the entity theory.

However, because our democratic social system has focused increased attention on its economic segment, the role of the business entity as an institution established by that system was emphasized. Attempts have been made to give cognizance to this role by accounting theorists but their approach has resulted in an acceptance of the entity theory as a basis for the recognition of the corporation as a social institution. The point of view advanced in this thesis is that the proprietary theory is better

fitted to this function.

Because economists have concerned themselves about this problem earlier and to a greater extent than have accountants some of their writings were examined. In general, their thoughts seem to be consistent with those of professional accountants. Yet, close examination of their writings results in the conclusion that inevitably, they return to the concept of stockholder ownership and direction of the affairs of the corporation regardless of how roundabout the route of travel is. It seems that the separate existence of the corporation is an illusion based upon characteristics of behavior peculiar to the time in which we live. Lack of interference in the conduct of the affairs of the organization does not mean that the owners are not concerned about their investment. It only means that they have by some subjective process established limits of tolerance within which interference is not worth the effort involved. Thus, as explained on page sixty nine of this thesis, William Baumol adopts the device of minimum profit constraint as a means of limiting the independence of corporate managers. On page sixty eight William Fellner refers to the unlikelihood of a real divergence of the interests of owners and managers. He also cautions against violation of the value judgments of society by management.

A corollary justification for the inclusion of a section in this thesis devoted to economic concepts was the development of the idea of minority control of the corporation. Mere mention of this possibility is sufficient. Its validity is very apparent in the financial news of the day.

As a result of the investigations conducted in chapter four, an inevitable conclusion is that corporate reports must be prepared for the use of the public, labor and consumers as well as for the stockholders. The role of the self-contained abstraction is too narrow to permit this interpretation.

It is perhaps easier to grasp the significance of certain problems associated with business combinations if they are examined within the context of reasoning applicable to the less complicated forms of grouping. Conclusions thereby achieved may be applied to the next higher level of amalgamation with little or no alteration.

Mergers and consolidations have taken place at an increasing rate during the past decade. Little concern has been expressed over the resulting diversification of operations. As a matter of fact, diversification has been a major motive for many combinations.

An essential feature of consolidations and mergers is the loss of identity of all or all but one of the participating corporations. This result is accomplished by either the purchase of assets or stock. If the latter method is chosen and one of the corporations emerges in a dominant role, the parent-subsidary relationship is approached. If so, the reasoning applicable to consolidations and mergers may be applied with considerable justification to the parent-subsidary association. Chapter five served the purpose of pointing out these relationships.

It is almost universally agreed that statements of the individual

corporation are inadequate for the purpose of disclosing facts pertaining to the economic entity. If the corporation is a parent company, its statements alone are not sufficient to reveal sufficient information even about it. The courts have in general subordinated consolidated statements to those of the individual corporation. Again, accountants have frequently accepted the leadership of the legal profession, thereby leaving the work of summarization and interpretation to interested parties. The same criticism may be applied in this instance as was earlier leveled at the entity concept of the corporation. If the social institution concept is accepted court decisions must be ignored as guides to policy in matters of this nature.

The two requirements for consolidation as revealed in chapter two were majority ownership of voting shares and homogeneity of operations. It has been suggested that the emphasis on majority ownership results from a misinterpretation of the pronouncements of the professional organizations reviewed herein, with the possible exception of Regulation S-X. The presumption has been that majority ownership results in control. That this need not be true is readily admitted by all the organizations investigated. The same bodies suggest the possibility of minority control but do not emphasize it. Accounting theorists readily admit this contingency, among them Messrs. Paton, Kohler and Moonitz. Economists discuss it at considerable length. For example, on page sixty seven of this dissertation Mr. Fellner's views on this point were stated. For these reasons chapter seven suggests that the percentage of ownership of voting shares be de-emphasized as a criterion for consolidation and promotes the concept of administrative control as a prerequisite.

Administrative control results in the determination of corporate policy.

The irrelevance of homogeneity as a criterion for the recognition of an economic entity is revealed by the lack of concern over this factor in the preparation of the statements of the individual corporation. It is treated in similar fashion under circumstances of consolidation or merger. In an economic environment which stresses diversification this requirement seems out of date. The requirement of integration is dismissed for the same reason. Both of these concepts may result in the creation of artificial units of endeavor and, hence, are considered useless as determining factors.

The labeling of chapter eight is somewhat misleading, if taken literally. Both topics discussed here are of considerable importance in the justification of the trend of thought presented in other sections of this thesis. The position of the non-controlling shareholders is of major significance in the social institution concept of the economic entity. They are not considered as quasi-creditors of the individual corporation or business combination, but as owners who although not presently dominant in the determination of policy may become so at some future date. Therefore, it is proper to eliminate all profit that occurs as a result of transactions within the entity. Moreover, all shareholders have an equal interest in the presentations of that entity. This results partly from the wider distribution of share ownership that is characteristic of the modern economic environment.

The method of investment valuation reveals much about the underlying attitude towards consolidation. If consolidation is in order there

is little reason to adjust the account for the share of undistributed subsidiary profits attributable to the parent company. Since the presumed objective of valuation at market is not achieved by adjustment of the investment account either, it is suggested that the account basically be valued at cost.

Combining statements are suggested if it is possible to emphasize homogeneity or integration thereby, but the pitfalls associated with this technique are stressed.

The problems associated with the inclusion of the accounts of foreign subsidiaries in consolidated statements are discussed in chapter nine. Situations involving foreign subsidiaries are considered to be basically no different than those involving domestic subsidiaries. The question to be answered is whether their location overseas results in the creation of deterrents to consolidation.

In chapter three doubt was expressed about the availability of funds invested in foreign ventures. Other reasons for concern about the wisdom of consolidating subsidiaries in foreign locations were given in chapters three and nine but they all evolved from a fear of restrictions on the transfer of funds. It was pointed out that these fears arose during the forties when war and the fear of war caused a conservative attitude to prevail. While this approach may have been justified by the events that transpired at that time its continuance is open to question. That the recent pronouncements of professional bodies have been so affected is

revealed by a comparison of their current publications with earlier releases on the same topic. Conservatism in its most severe form is revealed by such investigation. This attitude is not consistent with postwar developments.

Restrictions of all kinds have been greatly eased and in many countries are practically nonexistent. Investment overseas has taken place at an accelerated rate and has reached staggering size. Profits of most overseas ventures are substantial and in some cases, huge. The attitude of the companies with overseas affiliates has become truly multinational in nature. More companies are consolidating their foreign subsidiaries with the domestic parent company. The Federal government has recognized the weakness of the argument based upon restrictions by its passage of the Revenue Act of 1962 taxing income from foreign investments under certain circumstances.

It was therefore concluded that if administrative control exists at the time of preparation of financial statements the accounts of the foreign subsidiary should be consolidated with those of the parent. Lack of homogeneity or integration should not be permitted to prevent consolidation. If consolidation is not effected under these circumstances the burden of proof falls on the exhibitor of the statements. Not even restrictions at the real and monetary levels should interfere with the process if the parent company persist in the belief that the foreign operation remains under its control.

APPENDIX I

Accounting Research Bulletin No. 51
Consolidated Financial Statements

Purpose of Consolidated Statements

1. The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

Consolidation Policy

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy). There may also be situations where the minority interest in the subsidiary is so large, in relation to the equity of the shareholders of the

parent in the consolidated net assets, that the presentation of separate financial statements for the two companies would be more meaningful and useful. However, the fact that the subsidiary has a relatively large indebtedness to bondholders or others is not in itself a valid argument for exclusion of the subsidiary from consolidation. (Also, see Chapter 12 of Accounting Research Bulletin No. 43 for the treatment of foreign subsidiaries.)

3. In deciding upon consolidation policy, the aim should be to make the financial presentation which is most meaningful in the circumstances. The reader should be given information which is suitable to his needs, but he should not be burdened with unnecessary detail. Thus, even though a group of companies is heterogeneous in character, it may be better to make a full consolidation than to present a large number of separate statements. On the other hand, separate statements or combined statements would be preferable for a subsidiary or group of subsidiaries if the presentation of financial information concerning the particular activities of such subsidiaries would be more informative to shareholders and creditors of the parent company than would the inclusion of such subsidiaries in the consolidation. For example, separate statements may be required for a subsidiary which is a bank or an insurance company and may be preferable for a finance company where the parent and the other subsidiaries are engaged in manufacturing operations.

4. A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches

the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

5. Consolidated statements should disclose the consolidation policy which is being followed. In most cases this can be made apparent by the headings or other information in the statements, but in other cases a footnote is required.

Consolidation Procedure Generally

6. In the preparation of consolidated statements, intercompany balances and transactions should be eliminated. This includes intercompany open account balances, security holdings, sales and purchases, interest, dividends, etc. As consolidated statements are based on the assumption that they represent the financial position and operating results of a single business enterprise, such statements should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated; the concept usually applied for this purpose is gross profit or loss. (See also paragraph 17.) However, in a regulated industry where a parent or subsidiary manufactures or constructs facilities for other companies in the consolidated group, the foregoing is not intended to require the elimination of intercompany profit to

the extent that such profit is substantially equivalent to a reasonable return on investment ordinarily capitalized in accordance with the established practice of the industry.

Elimination of Intercompany Investments

7. Where the cost to the parent of the investment in a purchased¹ subsidiary exceeds the parent's equity in the subsidiary's net assets at the date of acquisition, as shown by the books of the subsidiary, the excess should be dealt with in the consolidated balance sheet according to its nature. In determining the difference, provision should be made for specific costs or losses which are expected to be incurred in the integration of the operations of the subsidiary with those of the parent, or otherwise as a result of the acquisition, if the amount thereof can be reasonably determined. To the extent that the difference is considered to be attributable to tangible assets and specific intangible assets, such as patents, it should be allocated to them. Any difference which cannot be so applied should be shown among the assets in the consolidated balance sheet under one or more appropriately descriptive captions. When the difference is allocated to depreciable or amortizable assets, depreciation and amortization policies should be such as to absorb the excess over the remaining life of related assets. For subsequent treatment of intangibles, see Chapter 5 of Accounting Research Bulletin No. 43.

¹See Accounting Research Bulletin No. 48, Business Combinations, for the difference in treatment between a purchase and a pooling of interests.

8. In general, parallel procedures should be followed in the reverse type of case. Where the cost to the parent is less than its equity in the net assets of the purchased subsidiary, as shown by the books of the subsidiary at the date of acquisition, the amount at which such net assets are carried in the consolidated statements should not exceed the parent's cost. Accordingly, to the extent that the difference, determined as indicated in paragraph 7, is considered to be attributable to specific assets, it should be allocated to them, with corresponding adjustments of the depreciation or amortization. In unusual circumstances there may be a remaining difference which it would be acceptable to show in a credit account, which ordinarily would be taken into income in future periods on a reasonable and systematic basis. A procedure sometimes followed in the past was to credit capital surplus with the amount of the excess; such a procedure is not now considered acceptable.

9. The earned surplus or deficit of a purchased¹ subsidiary at the date of acquisition by the parent should not be included in consolidated earned surplus.

10. When one company purchases two or more blocks of stock of another company at various dates and eventually obtains control of the other company, the date of acquisition (for the purpose of preparing consolidated statements) depends on the circumstances. If two or more purchases are made over a period of time, the earned surplus of the subsidiary at acquisition should

¹See Accounting Research Bulletin No. 48, Business Combinations, for the difference in treatment between a purchase and a pooling of interests.

generally be determined on a step-by-step basis; however, if small purchases are made over a period of time and then a purchase is made which results in control, the date of the latest purchase, as a matter of convenience, may be considered as the date of acquisition. Thus there would generally be included in consolidated income for the year in which control is obtained the postacquisition income for that year, and in consolidated earned surplus the postacquisition income of prior years, attributable to each block previously acquired. For example, if a 45% interest was acquired on October 1, 1957 and a further 30% interest was acquired on April 1, 1958, it would be appropriate to include in consolidated income for the year ended December 31, 1958, 45% of the earnings of the subsidiary for the three months ended March 31, and 75% of the earnings for the nine months ended December 31, and to credit consolidated earned surplus in 1958 with 45% of the undistributed earnings of the subsidiary for the three months ended December 31, 1957.

11. When a subsidiary is purchased during the year, there are alternative ways of dealing with the results of its operations in the consolidated income statement. One method, which usually is preferable, especially where there are several dates of acquisition of blocks of shares, is to include the subsidiary in the consolidation as though it had been acquired at the beginning of the year, and to deduct at the bottom of the consolidated income statement the preacquisition earnings applicable to each block of stock. This method presents results which are more indicative of the current status of the group, and facilitates future comparison with subsequent years. Another method of prorating income is to include in the consolidated statement only the subsidiary's revenue and expenses subsequent to the date of acquisition.

12. Where the investment in a subsidiary is disposed of during the year, it may be preferable to omit the details of operations of the subsidiary from the consolidated income statement, and to show the equity of the parent in the earnings of the subsidiary prior to disposal as a separate item in the statement.

13. Shares of the parent held by a subsidiary should not be treated as outstanding stock in the consolidated balance sheet.

Minority Interests

14. The amount of intercompany profit or loss to be eliminated in accordance with paragraph 6 is not affected by the existence of a minority interest. The complete elimination of the intercompany profit or loss is consistent with the underlying assumption that consolidated statements represent the financial position and operating results of a single business enterprise. The elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests.

15. In the unusual case in which losses applicable to the minority interest in a subsidiary exceed the minority interest in the equity capital of the subsidiary, such excess and any further losses applicable to the minority interest should be charged against the majority interest, as there is no obligation of the minority interest to make good such losses. However, if future earnings do materialize, the majority interest should be credited to the extent of such losses previously absorbed.

Income Taxes

16. When separate income tax returns are filed, income taxes usually are incurred when earnings of subsidiaries are transferred to the parent. Where it is reasonable to assume that a part of all of the undistributed earnings of a subsidiary will be transferred to the parent in a taxable distribution, provision for related income taxes should be made on an estimated basis at the time the earnings are included in consolidated income, unless these taxes are immaterial in amount when effect is given, for example, to dividend-received deductions or foreign-tax credits. There is no need to provide for income tax to the parent company in cases where the income has been, or there is evidence that it will be, permanently invested by the subsidiaries, or where the only likely distribution would be in the form of a tax-free liquidation.

17. If income taxes have been paid on intercompany profits on assets remaining within the group, such taxes should be deferred or the intercompany profits to be eliminated in consolidation should be appropriately reduced.

Stock Dividends of Subsidiaries

18. Occasionally, subsidiary companies capitalize earned surplus arising since acquisition, by means of a stock dividend or otherwise. This does not require a transfer to capital surplus on consolidation, inasmuch as the retained earnings in the consolidated financial statements should reflect the accumulated earnings of the consolidated group not distributed to the shareholders of, or capitalized by, the parent company.

Unconsolidated Subsidiaries in Consolidated Statements

19. There are two methods of dealing with unconsolidated subsidiaries in consolidated statements. Whichever method is adopted should be used for all unconsolidated subsidiaries, subject to appropriate modification in special circumstances. The preferable method, in the view of the committee, is to adjust the investment through income currently to take up the share of the controlling company or companies in the subsidiaries' net income or net loss, except where the subsidiary was excluded because of exchange restrictions or other reasons which raise the question of whether the increase in equity has accrued to the credit of the group. (Adjustments of the investment would also be made for "special" debits or credits shown on the income statements of the unconsolidated subsidiaries below the net income for the period, and for similar items shown in the schedule of earned surplus.) The other method, more commonly used at present, is to carry the investment at cost, and to take up income as dividends are received; however, provision should be made for any material impairment of the investment, such as through losses sustained by the subsidiaries, unless it is deemed to be temporary. When the latter method is followed, the consolidated statements should disclose, by footnote or otherwise, the cost of the investment in the unconsolidated subsidiaries, the equity of the consolidated group of companies in their net assets, the dividends received from them in the current period, and the equity of the consolidated group in their earnings for the period; this information may be given in total or by individual subsidiaries or groups of subsidiaries.

20. Whichever method of dealing with unconsolidated subsidiaries is followed, if there is a difference between the cost of the investment and the equity in net assets at the date of acquisition, appropriate recognition should be given to the possibility that, had the subsidiaries been consolidated, part of such difference would have been reflected in adjusted depreciation or amortization. Also, appropriate recognition should be given to the necessity for an adjustment for intercompany gains or losses on transactions with unconsolidated subsidiaries. If sales are made to unconsolidated subsidiaries and the investment in the subsidiaries is carried at cost plus the equity in undistributed earnings, an elimination of unrealized intercompany gains and losses should be made to the same extent as if the subsidiaries were consolidated. The same applies where intercompany sales are made by the unconsolidated subsidiaries. If, however, the investment is carried at cost, it is not necessary to eliminate the intercompany gain on sales to such subsidiaries, if the gain on the sales does not exceed the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries. If such gain is material, it should be appropriately disclosed. Where the sales are made by the unconsolidated subsidiaries to companies included in the consolidated group, the intercompany gains or losses should be eliminated in arriving at the amount of the equity in the undistributed earnings of the unconsolidated subsidiaries which will be disclosed in a footnote or otherwise. (See paragraph 19)

21. Where the unconsolidated subsidiaries are, in the aggregate, material in relation to the consolidated financial position or operating results, summarized information as to their assets, liabilities and operating results should be given in the footnotes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate.

Combined Statements

22. To justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation. There are circumstances, however, where combined financial statements (as distinguished from consolidated statements of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations. Combined statements would also be used to present the financial position and the results of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.

23. Where combined statements are prepared for a group of related companies, such as a group of unconsolidated subsidiaries or a group of commonly controlled companies, intercompany transactions and profits or losses should be eliminated, and if there are problems in connection with such matters as minority interests, foreign operations, different fiscal periods,

or income taxes, they should be treated in the same manner as in consolidated statements.

Parent-Company Statements

24. In some cases parent-company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating statements, in which one column is used for the parent company and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information.

The statement entitled "Consolidated Financial Statements" was unanimously adopted by the twenty-one members of the committee, of whom nine, Messrs. Bedford, Dunn, Graese, Graham, Halverson, Hoyler, Kent, Powell, and Werntz, assented with qualification.

Mr. Bedford objects to the provision in paragraph 2 that ownership of over fifty per cent of the outstanding voting stock is the general rule governing consolidation policy. He believes the over fifty per cent ownership requirement is at best only one of several criteria evidencing the existence of a consolidated entity.

Messrs. Graese and Hoyler do not agree with the statement made in the last sentence of paragraph 8. Mr. Graese believes there are cases in which the crediting of a capital surplus account with the "excess credit" will result in a more appropriate presentation of consolidated operations and financial position, particularly in (but not limited to) situations where

the acquisition of control of the subsidiary has been accomplished over an extended period of time or where there are acquisitions of minority interest at a date considerably after obtaining control. Mr. Hoyler is of the opinion that there have been, and probably will be, circumstances under which credits to capital surplus of the excesses referred to in this paragraph will be appropriate.

Mesars. Halvorson and Werntz object to the relative emphasis given to the recommendations in paragraph 10, which they believe should be reversed. They believe that the date of the purchase which results in control should generally be considered to be the date of acquisition; however, if a limited number of purchases are made over a period of time pursuant to a plan or program which culminates in control, they agree that the earned surplus of the subsidiary at acquisition may be determined on a step-by-step basis.

Mr. Halvorson disagrees with the recommendation in paragraph 18. In his view, the usual subsidiary is a closely held corporation, and consequently is under no pressure to declare stock dividends and is under no compulsion to follow the "fair value" method of accounting for them if it does. If it does capitalize earned surplus by means of a stock dividend or otherwise, particularly "otherwise," he feels that it must have been done with a purpose relating to its financial position, at the direction of, and with the acquiescence of, the parent company, and that the capitalization should carry through into the consolidated surplus accounts. If the subsidiary is one in which there is publicly held minority interest, and a

stock dividend is issued and accounted for on a fair-value basis in the manner of an independent publicly owned corporation, the accounting for earned surplus in respect to the majority interest would be the same as that for the minority interest, and again he believes that the capitalization should follow through into the consolidated surplus accounts. Mr. Powell also disagrees with the conclusion expressed in this paragraph. He believes that if a parent causes a subsidiary to freeze a part or all of its earned surplus through the payment of a stock dividend or otherwise, thus making such surplus unavailable for ordinary dividends, it should follow a similar procedure on consolidation.

Mr. Kent believes the consolidation policy section is deficient since it fails to restrict the increasing practice of not including certain subsidiaries in consolidated financial statements. He suggests that the bulletin may possibly result in further increasing such practice as a consequence of the preference expressed in paragraph 19 for the inclusion of the equity in earnings of unconsolidated subsidiaries in consolidated statements. It is his belief that in the usual situation a full consolidation policy as implied in paragraph 1 is generally preferable, supplemented by such summarized financial information, in footnotes or otherwise, as may be appropriate.

Messrs. Dunn and Graham believe that the "preferable" method in paragraph 19 should be recognized as the only acceptable method of dealing with unconsolidated subsidiaries in consolidated statements, and that the

method which carries the investment in unconsolidated subsidiaries at cost, and takes up as income only the dividends received, should be discontinued as rapidly as is practicable. They feel that the "preferable" method conforms to the purpose of consolidated statements as set forth in paragraph 1 -- to present the results of operations and the financial position essentially as if the group were a single company, and that its uniform adoption would increase the comparability of the financial statements of different companies, and would avoid the possibility of manipulation of reported consolidated earnings through the control of dividends received by the parent.

Mr. Dunn believes that paragraph 20 should require the elimination of intercompany gain on sales to unconsolidated subsidiaries if the failure to do so would have a material effect on the reported consolidated income, regardless of whether the gain on intercompany sales exceeds the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries.

APPENDIX II

Consolidated Financial Statements

In connection with its continuing study of the concrete meaning of "business entity," the Committee on Concepts and Standards has selected the area of consolidated financial statements as one of importance.

Basic Principles of Consolidated Financial Statements

1. In the absence of special circumstances, consolidated statements are useful representations of financial position and results of operations when a dominant central financial interest in two or more companies exists and is accompanied by administrative control of their activities and resources.

2. Insofar as practicable, the consolidated data should reflect the underlying assumption that they represent the operations, resources, and equities of a single entity.

The first principle is a statement of policy, of objective, defining broadly the entity or area of consolidation; the second principle sets forth a general guide to the procedures of consolidation.

Discussion of First Principle

(a) During the past half-century, consolidated statements have constituted an increasing proportion of the published financial reports of American corporations. Furthermore, the tendency to present consolidated statements alone, unaccompanied by the separate statements of constituent companies, has increased. These trends strongly imply that the consolidated statements are more useful than the separate statements, and may now be primary rather

than secondary or supplemental. Under some circumstances, however, the separate statements of the constituent units are of consequence and should be published.

Because the investors in the parent company are usually the ones with a continuing interest in the operations of the affiliated companies as a group, consolidated financial statements are of primary significance to them, rather than to the minority investors in any subsidiary. While the latter group may find use for consolidated statements, their primary concern is with the financial statements of the separate corporations in which they have financial interests.

The essential unity of the group of affiliated companies is most apparent when all the outstanding capital stock of each subsidiary is completely owned by the parent company, when no subsidiary has any significant funded debt, and when each subsidiary is operated as if it were a department or division of the parent. In those cases where important outside financial interests exist (e.g., preferred stocks, funded debt, minority interest in common stocks), it is necessary to determine if a "dominant central financial interest" exists, and if this dominant interest has "administrative control" of the activities and resources of all affiliates.

(b) The existence of a "dominant central financial interest" is a quality, a condition. Usually the presence of this interest is clear-cut and recognizable. When, however, its existence is not obvious its evaluation involves consideration of the amount and type of share ownership among affiliates, representation on the board of directors, restrictive clauses in

bond and share contracts, restrictive legislation, etc. Ownership of a substantial percentage of voting shares is ordinarily prerequisite to the existence of such interest, but, taken alone, share ownership may not in specific cases be sufficient for its establishment and continuance. Furthermore, a group of companies may be interrelated in a manner such that no one company or other financial interest stands out as dominant. In these circumstances, consolidation may not be useful. In most cases, however, ownership of a majority of the voting shares outstanding is sufficient to establish a prima facie case that a dominant central financial interest exists.

The first principle covers the conventional case of a central financial interest based primarily on share ownership by a parent company, as well as the case of ownership by a group which has identical proportionate interests in several enterprises, incorporated or unincorporated. The preparation of combined financial statements in the latter case is not being urged; instead, the point is being made that the principle enunciated above is broad enough to encompass extension of current practice when, as, and if an extension would accomplish some useful purpose.

(c) "Administrative control" is also a quality or condition, referring to the actual integration and direction of the activities of the affiliates. Administrative control implies that each constituent unit is operated as if it were a department or branch of a larger entity. An affiliate, to be included in consolidation, must ordinarily manufacture a product or perform a function or render a service which contributes directly to the activities in

which the overall enterprise is primarily engaged. Consolidated statements are useful representations when integration of the productive and distributive processes is accomplished through the interrelated activities of the parent company and its subsidiaries. In some instances, the activities of an enterprise may be so extensively integrated that a subsidiary is performing a function, such as a finance or insurance function, which extends beyond the ordinary productive and distributive processes. A subsidiary of this type may be excluded from consolidation in order to avoid the commingling of dissimilar assets and sources of income. In view, however, of the marked trend toward diversification of activities on the part of American businesses, care should be exercised in the use of the "primary activity" of the enterprise as a criterion of inclusion or exclusion.

(d) Some examples of cases in which it may be desirable to exclude a subsidiary from consolidation are listed below:

(1) The control by the parent company is likely to be temporary, or is limited by legal restrictions.

(2) A relatively large amount of non-voting common stock or of preferred stock is held by the minority interest, with the result that a dominant central financial interest does not exist.

(3) The balance sheet dates of the affiliates do not fall within a reasonably short period of time. If a central financial interest and administrative control exist, the balance-sheet dates should, if possible, be made compatible in order to permit inclusion of the affiliates in the consolidated statements.

(4) With disturbed conditions in foreign countries, which may take the form of exchange restrictions or unstable political or economic conditions, it may be desirable to omit some or all foreign subsidiaries from consolidation. In any case, appropriate disclosure of the results of foreign operations and of their status in the consolidated statements should be made.

(e) If a majority-owned affiliate is omitted from consolidation, reasons for the exclusion should be given. The explanation would refer, for example, to administrative control which is incomplete for some specifically stated reason or law, custom, or economic condition which dictates that the operations of the excluded unit must be carried on by a separate company and cannot be integrated with those of its affiliates. Where the excluded company is significant in size or other aspect, appropriate disclosure should be made of the parent's share of (1) the subsidiary's profits or losses for the current accounting period, (2) the dividends declared by the subsidiary during such period, and (3) the subsidiary's undistributed earnings from date of acquisition. Under these circumstances, a strong presumption exists that separate statements of the subsidiary would accompany the consolidated statements.

(f) Published statements should disclose the principles of consolidation actually followed. Such disclosure is particularly important at the present time because of the diversity of rules and standards in current use.

Discussion of Second Principle

(a) Intercompany pairs of accounts, reciprocal in nature, are to be eliminated. This second principle stems from the desirability of avoiding double-counting and of eliminating the portion of any profit recorded on intercompany

transactions that is unrealized, at the balance-sheet date, from the point of view of the affiliated group as an entity.

Among the types of intercompany pairs of accounts which are eliminated to avoid double-counting are receivable-payable accounts, revenue-expense accounts, bonds and other long-term debt held intercompany, shares of capital stock held intercompany, and dividends on shares of stock held intercompany.

(b) In the elimination of shares of stock held intercompany, the following points are of special importance:

(1) The difference between the price paid and the underlying book value of the interest acquired should be disposed of according to the reasons for its existence. For example, if specific assets of a subsidiary are undervalued or overvalued, they should, in consolidation, be restated to conform to the level employed in arriving at the price for the shares; if the shares were acquired by an exchange of securities, the possible existence of premium or discount on the securities issued for the shares should be investigated; if the acquiring company has paid for the shares partly on the basis of a previously unrecorded intangible, an appropriate asset, properly described, should be introduced into the consolidated financial statements.

(2) Consolidated retained earnings consist of the retained earnings of the parent, or controlling interest, plus the portion, or portions, of subsidiary-company earnings accumulated subsequent to the date or successive dates of acquisition, and attributable to the shares making up the controlling interest.

(3) Shares of the controlling company's capital stock owned by a subsidiary before the date of acquisition of control should be treated in consolidation as treasury stock. Any subsequent acquisition or sale by a subsidiary should likewise be treated in the consolidated statements as though it had been the act of the controlling company.

(c) In the consolidated financial statements, no gain or loss should be recognized as the result of transactions among affiliates. From a combined point of view, these transactions result merely in a shift of assets from one department or branch to another department or branch of the same entity. Therefore:

(1) The elimination of intercompany markups in assets should be complete, irrespective of the presence or absence of an outside (minority) interest. This procedure is necessary to insure a cost basis which, properly, should not be affected by the pattern of share ownership.

(2) The amount of intercompany markup to be eliminated is the intercompany gross margin, reduced by any inventoriable costs incurred in the movement of the goods from one affiliate to another.

(3) The intercompany gain to be eliminated from assets logically is applied in consolidation as a reduction of the income or retained earnings of the affiliates that have recorded the gain. If any such affiliate is a subsidiary with a minority interest, the per share equity of that interest is thus reduced, in the consolidated statements, in the same manner and in the same proportionate amount as the controlling interest. The practice of reflecting a minority interest's share of unrealized intercompany profit as

if realized, while widely accepted, conflicts with the underlying purpose of consolidated financial statements as herein contemplated, namely, to reflect the activities of a group of companies as though they constituted a single unit.

APPENDIX III

Regulation S-X
Form and Content of Financial Statements

Rule 4-01. Application of Article 4.

This article shall govern the preparation of consolidated and combined statements.

Rule 4-02. Consolidated Statements of the Registrant and Its Subsidiaries.

The registrant shall follow in the consolidated statements principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the registrant and its subsidiaries: Provided, however, That--

(a) The registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary;

(b) If the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if all the following conditions exist; (1) Such difference is not more than 93 days; (2) the closing date of the subsidiary is expressly indicated; (3) the necessity for the use of different closing dates is briefly explained; and (4) any changes in the respective fiscal periods of the registrant and the subsidiary made during the period of report are clearly indicated, together with the manner of treatment;

(c) Consolidation of foreign subsidiaries.--Due consideration shall be given to the propriety of consolidating with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign

currencies. If consolidated, disclosure should be made as to the effect, insofar as this can be reasonably determined, of foreign exchange restrictions upon the consolidated financial position and operating results of the registrant and its subsidiaries.

Rule 4-03. Group Statements of Subsidiaries Not Consolidated.

For majority-owned subsidiaries not consolidated with the registrant there may be filed statements in which such subsidiaries are consolidated or combined in one or more groups pursuant to principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the group or groups. If it is essential to a properly summarized presentation of the facts, such consolidated or combined statement shall be filed.

Rule 4-04. Statement as to Principle of Consolidation or Combination Followed.

(a) The principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated balance sheet and in each group balance sheet of unconsolidated subsidiaries shall be stated in a note to the respective balance sheet.

(b) As to each consolidated statement and as to each group statement of unconsolidated subsidiaries, a statement shall be made as to whether there have been included or excluded any persons not similarly treated in the corresponding statement for the preceding fiscal period filed with the Commission. If the answer to the foregoing is in the affirmative, the names of such persons shall be given.

Rule 4-05. Reconciliation of Investment of Parent in Subsidiaries and Fifty-Percent Owned Persons and Equity of Parent in Their Net Assets.

(a) Consolidated subsidiaries.--There shall be set forth in a note to each consolidated balance sheet filed a statement of any difference between the investment in subsidiaries consolidated, as shown by the parent's books, and the parent's equity in the net assets of such subsidiaries, as shown by the books of the latter. If any such difference exists, there shall be set forth the amount of the difference and the disposition made thereof in preparing the consolidated statements, naming the balance sheet captions and stating the amount included in each.

(b) Subsidiaries not consolidated.--A statement shall be made of the amount of any difference between the investment of the parent and its consolidated subsidiaries, as shown by their books, in the unconsolidated subsidiaries and fifty-percent owned persons for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, and fifty-percent owned persons, as shown by the books of the latter.

Rule 4-06. Reconciliation of Dividends Received From, and Earnings of, Unconsolidated Subsidiaries.

The proportion of the sum of, or difference between, current earnings or losses and the dividends declared or paid by the unconsolidated subsidiaries required to be included in the schedule prescribed by rule 12-17 that is applicable to the parent and its consolidated subsidiaries shall be set forth in a note to each consolidated profit and loss statement.

Rule 4-07. Minority Interests.

(a) Minority interests in the net assets of subsidiaries consolidated shall be shown in each consolidated balance sheet. Separation shall be made between the minority interest in the capital and in the surplus.

(b) The aggregate amount of profit and loss accruing to minority interests shall be stated separately in each consolidated profit and loss statement.

Rule 4-08. Intercompany Items and Transactions.

In general, intercompany items and transactions shall be eliminated. If not eliminated, a statement of the reasons and the methods of treatment shall be made.

Rule 4-09. Special Requirements as to Insurance Companies.

(a) Except as provided in paragraph (b) of this rule, the statements of an insurance company shall not be consolidated or combined with the statements of any person.

(b) The statements of an insurance company other than a life insurance company may be consolidated if all of the following conditions exist:

(1) The insurance company is a totally-held subsidiary of the top parent included in the consolidation;

(2) Such top parent is not an insurance company, investment company, or bank holding company;

(3) The insurance company engages in no business of a material amount other than the insuring of risks arising in the ordinary course of business

of such top parent and its other subsidiaries; and

- (4) Separate financial statements for the insurance company are filed.

Rule 4-10. Special Requirements as to Registrants Which Are Bank Holding Companies.

If the registrant is a bank holding company--

- (a) Statements of the registrant may be consolidated only with the statements of subsidiaries which are bank holding companies.

- (b) A consolidated statement of the registrant and any of its bank holding company subsidiaries shall not be filed unless accompanied by a consolidating statement which sets forth the individual statements of each subsidiary included in the consolidated statement.

- (c) Consolidated or combined statements filed for subsidiaries not consolidated with the registrant shall not include any bank holding companies unless accompanied by consolidating or combining statements which set forth the individual statements of each included bank holding company subsidiary.

Rule 4-12. Special Requirements as to Banks.

If two or more majority-owned subsidiaries of a person are banks and are directly owned by a single parent, there shall be filed, in lieu of individual statements for such subsidiaries, combined statements showing the minority interest separately and eliminating any material inter-bank items; except that the statements of any such subsidiary which on the date of filing is a closed or liquidating bank shall not be included in any

combined statement. Except as provided in the preceding sentence, statements of banks shall not be included in any consolidated or combined statements.

Rule 4-13. Special Requirements as to Public Utility Holding Companies.

There shall be shown in the consolidated balance sheet of a public utility holding company the difference between the amount at which the parent's investment is carried and the underlying book equity of subsidiaries as at the respective dates of acquisition.

Rule 4-14. Special Requirements as to Commercial, Industrial and Mining Companies in the Promotional, Exploratory, or Development Stage Subject to Article 5A.

The financial statements required by article 5A shall not be prepared on a consolidated basis but shall, insofar as practicable, be prepared so as to show the information for the registrant and each of its subsidiaries in parallel columns.

Section 2: Balance Sheet

Appendix IV

TABLE 47: CONSOLIDATION OF SUBSIDIARY COMPANIES

Consolidation Policy	Location of Subsidiaries				1960 Total Companies
	Domestic Only	Domestic and Foreign	Foreign Only	Not Indicated	
Fully consolidated financial statements (a) (*Co. Nos. 4, 153, 271, 390, 411); (b) (*Co. Nos. 57, 451, 526, 531, 546); (c) (*Co. Nos. 25, 115, 272, 314, 358)	(a) 104	(b) 128	(c) 17	9	258
Partially consolidated financial statements**	28	223	7	—	258
Unconsolidated financial statements (d) (*Co. Nos. 227, 229, 231, 408); (e) (*Co. Nos. 304, 475; (f) (*Co. Nos. 258, 324, 394)	(d) 9	(e) 2	(f) 9	—	20
Total Companies having subsidiaries	<u>141</u>	<u>353</u>	<u>33</u>	<u>9</u>	<u>536</u>
Companies having no subsidiaries					<u>64</u>
Total					<u>600</u>

<u>**Partially Consolidated Financial Statements—Consolidation Policy</u>	<u>1960 Total Companies</u>
<i>Companies having domestic subsidiaries only:</i>	
Wholly-owned, active subsidiaries consolidated (*Co. Nos. 88, 333, 425, 533)	7
Significant, principal, and active subsidiaries included (*Co. Nos. 21, 175, 463, 528)	4
All subsidiaries consolidated except those with non-homogeneous operations (*Co. Nos. 144, 193, 363, 371, 525, 571)	12
Basis not indicated (*Co. Nos. 47, 84, 143, 147, 298)	5
Total companies having domestic subsidiaries only	<u>28</u>
<i>Companies having domestic and foreign subsidiaries:</i>	
All domestic subsidiaries consolidated, with following treatment of foreign subsidiaries (83 companies):	
Exclusion of all (*Co. Nos. 64, 82, 137, 155, 208)	40
Exclusion based upon geographic location or geographic location plus other factors (*Co. Nos. 27, 449, 458, 548, 588)	39
Basis not indicated (*Co. Nos. 156, 539)	4
Wholly-owned, active domestic subsidiaries consolidated, with following treatment of foreign subsidiaries (56 companies):	
Inclusion of all wholly-owned and active (*Co. Nos. 32, 87, 112, 139, 141, 437)	32
Exclusion of all (*Co. Nos. 92, 135, 168, 178)	11
Exclusion based upon geographic location or geographic location plus other factors (*Co. Nos. 409, 485, 536)	11
Other basis indicated (*Co. Nos. 265, 529)	2
Only subsidiaries with operations homogeneous to those of the parent company consolidated, with following treatment of foreign subsidiaries (32 companies):	
Inclusion of, based on homogeneous operations (*Co. Nos. 1, 6, 252, 308)	11
Inclusion of all (*Co. Nos. 128, 145, 598)	6
Exclusion of all (*Co. Nos. 39, 471, 489)	6
Exclusion based on location (*Co. Nos. 16, 72, 190, 250)	8
Not indicated (*Co. No. 279)	1
Other variations (52 companies):	
All subsidiaries based on voting control or fixed percentage of ownership (*Co. Nos. 46, 311, 370, 505)	7
All significant, principal, and active subsidiaries included (*Co. Nos. 54, 142, 166, 553)	8
Domestic, significant subsidiaries included with some foreign subsidiaries excluded on basis of geographic location (*Co. Nos. 62, 70, 136)	7
Other basis stated (*Co. Nos. 105, 306, 429)	6
Basis not indicated (*Co. Nos. 78, 126, 200, 401, 472, 482)	24
Total companies having domestic and foreign subsidiaries	<u>223</u>
<i>Companies having foreign subsidiaries only:</i>	
Exclusion based upon geographic location or geographic location plus other factor(s) (*Co. Nos. 42, 130, 255, 261, 324, 394, 524)	7
Total companies having foreign subsidiaries only	<u>7</u>
Total companies partially consolidating financial statements	<u>258</u>

*Refer to Company Appendix Section.

Consolidation of Subsidiaries

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Appendix V

TABLE 44: CONSOLIDATION OF SUBSIDIARY COMPANIES

Consolidation Policy	Location of Subsidiaries				1955 Total Companies
	Domestic Only	Domestic and Foreign	Foreign Only	Not Indicated	
1. Fully Consolidated Financial Statements	127	95	8	21	251
Partially Consolidated Financial Statements—					
<i>Companies having domestic subsidiaries only:</i>					
2. Wholly-owned, active subsidiaries consolidated	9	—	—	—	9
3. Significant, principal, and active subsidiaries included	4	—	—	—	4
4. All subsidiaries consolidated except those with non-homogeneous operations	6	—	—	—	6
5. All majority-owned subsidiaries consolidated except those with non-homogeneous operations	2	—	—	—	2
6. Inclusion based upon fixed percentage of ownership	2	—	—	—	2
7. Other basis stated	3	—	—	—	3
8. Basis not indicated	5	—	—	—	5
<i>Companies having domestic and foreign subsidiaries:</i>					
All domestic subsidiaries consolidated, with following treatment of foreign subsidiaries (67 companies):					
9. Exclusion of all	—	32	—	—	32
10. Exclusion based upon geographic location	—	11	—	—	11
11. Exclusion based upon geographic location <i>plus</i> other factor(s) of operation, ownership, significance, etc.	—	1	—	—	1
12. Inclusion based upon fixed percentage of ownership	—	5	—	—	5
13. Inclusion of wholly-owned	—	1	—	—	1
14. Exclusion based upon other stated basis	—	1	—	—	1
15. Basis not indicated	—	16	—	—	16
Wholly-owned, active domestic subsidiaries consolidated, with following treatment of foreign subsidiaries:					
16. Inclusion of all wholly-owned and active	—	24	—	—	24
17. Exclusion of all	—	6	—	—	6
18. Exclusion based upon geographic location	—	3	—	—	3
19. Exclusion based upon geographic location <i>plus</i> other factor(s) of operation, ownership, significance, etc.	—	4	—	—	4
All domestic subsidiaries consolidated except those with non-homogeneous operations, with following treatment of foreign subsidiaries (13 companies):					
20. Inclusion of all	—	5	—	—	5
21. Exclusion of all	—	3	—	—	3
22. Exclusion based upon geographic location	—	3	—	—	3
23. Basis not indicated	—	2	—	—	2
24. Significant and homogeneous domestic subsidiaries consolidated; some foreign subsidiaries excluded on basis of geographic location	—	3	—	—	3
25. Others with foreign subsidiaries excluded on basis of geographic location	—	3	—	—	3
26. All foreign subsidiaries included; some domestic subsidiaries excluded because of factor(s) of operation, ownership, significance, etc.	—	2	—	—	2
27. Majority-owned and homogeneous domestic subsidiaries consolidated; all foreign subsidiaries excluded	—	1	—	—	1
28. All subsidiaries based on fixed percentage of ownership	—	4	—	—	4
29. Significant, principal and active subsidiaries included	—	7	—	—	7
30. Basis not indicated	—	25	—	—	25
<i>Companies having only foreign subsidiaries:</i>					
31. Exclusion based upon geographic location	—	—	4	—	4
32. Exclusion based upon geographic location <i>plus</i> factor(s) of operation, ownership, significance, etc.	—	—	2	—	2
33. Basis not indicated	—	—	1	—	1
34. Location of subsidiaries not determinable	—	—	—	10	10
Total companies having consolidated subsidiaries	158	257	15	31	461
35. Unconsolidated Financial Statements	(a) 13	(b) 12	(c) 10	(d) 3	38
Total companies having subsidiaries	171	269	25	34	469
Companies having no subsidiaries					101
					600

Consolidation of Subsidiaries

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Appendix VI

TABLE 46: CONSOLIDATION OF SUBSIDIARY COMPANIES

Basis of Consolidation	Domestic			Foreign			
	1953	1952	1951	1953	1952	1951	
<i>Stated—</i>							
All subsidiaries included in consolidation	67	62	60	20	19	20	
Wholly-owned subsidiaries consolidated	14	12	10	9	7	7	
Wholly-owned active subsidiaries consolidated	1	1	1	1	1	1	
Based on a fixed percentage of ownership	1	1	2	1	3	2	
Significant subsidiaries consolidated	3	5	4	1	1	1	
Significant and active subsidiaries consolidated	—	—	—	1	1	—	
Active subsidiaries consolidated	1	1	1	1	1	1	
Subsidiaries with operations homogeneous to those of the parent company consolidated	7	7	6	—	—	—	
Majority-owned significant subsidiaries with operations homogeneous to those of the parent company consolidated	1	—	—	—	—	—	
Significant subsidiaries with operations homogeneous to those of the parent company consolidated	1	1	1	—	—	—	
Only domestic sales subsidiaries consolidated	1	1	1	—	—	—	
Based on degree of voting control of subsidiaries	—	—	—	2	1	2	
Based on foreign location of subsidiaries	—	—	—	24	22	16	
Based on foreign location and degree of ownership of subsidiaries	—	—	—	2	1	3	
Based on foreign location plus varying factors of ownership, active operation, significance, etc. of subsidiaries	—	—	—	3	1	1	
All subsidiaries excluded from consolidation	4	3	3	25	23	22	
	<u>101</u>	<u>94</u>	<u>89</u>	<u>90</u>	<u>81</u>	<u>76</u>	
<i>Indicated: By inclusion of all subsidiaries in consolidation—</i>							
Domestic or foreign location	237	245	237	80	83	78	
Location not determinable	15	15	20	—	—	—	
<i>Indicated: By exclusion of all subsidiaries from consolidation—</i>							
Domestic or foreign location	19	25	22	53	55	59	
Location not determinable	12	10	8	—	—	—	
	<u>283</u>	<u>295</u>	<u>287</u>	<u>133</u>	<u>138</u>	<u>137</u>	
<i>Not Determinable: Certain subsidiaries included in consolidation and other subsidiaries excluded from consolidation—</i>							
Domestic or foreign location	32	31	41	27	29	28	
Location not determinable	24	21	20	—	—	—	
	<u>56</u>	<u>52</u>	<u>61</u>	<u>27</u>	<u>29</u>	<u>28</u>	
Total	<u>440</u>	<u>441</u>	<u>437</u>	<u>250</u>	<u>248</u>	<u>241</u>	
<i>Summary:</i>							
Consolidated subsidiaries only	319	323	318	100	102	98	
Consolidated and unconsolidated subsidiaries	86	80	86	72	68	62	
Unconsolidated subsidiaries only	35	38	33	78	78	81	
Total	<u>440</u>	<u>441</u>	<u>437</u>	<u>250</u>	<u>248</u>	<u>241</u>	
<i>Number of Companies With:</i>							
Consolidated subsidiaries only	259	268	260	Domestic subsidiaries only	185	194	194
Consolidated and unconsolidated subsidiaries	182	174	182	Subsidiaries—not described	51	46	48
Unconsolidated subsidiaries only	45	46	41	Domestic and foreign subsidiaries	204	201	195
Total	486	488	483	Foreign subsidiaries only	46	47	46
No subsidiaries	114	112	117	Total	486	488	483
	<u>600</u>	<u>600</u>	<u>600</u>	No subsidiaries	114	112	117
					<u>600</u>	<u>600</u>	<u>600</u>

consolidation, one reason undoubtedly being the widespread restrictions in many foreign countries on the transfer of earnings to this country. Subsidiaries with operations which are not homogeneous with those of the parent company (as for example a financing company owned by a manufacturing company) are

commonly not included in the consolidated financial statements.

The various bases of consolidation with regard to both domestic and foreign subsidiaries, as disclosed by the survey companies in their annual reports for the years 1951 through 1953, are set forth in Table 46.

Section 2: Balance Sheet

Appendix VII

TABLE 21: UNCONSOLIDATED SUBSIDIARY AND AFFILIATED COMPANIES

Balance Sheet Presentation	I: Unconsolidated Subsidiary			II: Affiliated Companies		
	1960	1955	1951	1960	1955	1951
Investment in	141	117	116	133	118	91
Investment in, Advances to	99	82	82	55	39	39
Investment in, Advances to, Receivables due from	1	—	3	—	1	1
Investment in, Receivables due from	18	15	21	10	11	12
Advances to or due from	—	1	1	—	2	1
Equity in net assets	2	—	—	—	—	—
Securities or stock of	—	2	—	4	1	—
Securities or stock of, and advances to	2	—	—	1	—	—
Other assets	3	3	—	1	1	—
Total	266	220	223	204	173	144
Basis of Valuation						
A: Cost	121	93	104	124	94	78
B: Cost less reserve	27	25	18	13	20	16
C: Cost or below cost	20	21	15	26	19	14
D: Cost adjusted for equity in earnings	16	5	3	5	—	—
E: Cost less dividends	2	1	—	1	2	1
F: Substantially at cost	1	1	2	—	—	—
G: Below cost	—	1	—	—	—	—
H: "Not in excess of cost"	2	2	2	1	1	1
I: Lower of cost or estimated value	1	1	1	—	—	—
J: Assigned, appraisal, or reorganization value	2	—	3	—	—	4
K: Equity in net assets	30	7	9	1	2	—
L: Equity in net worth less reserves	3	2	3	—	—	—
M: Equity less unremitted profits	2	1	3	1	—	—
N: Dated equity value	—	2	1	—	—	—
O: Asset values at acquisition	1	1	1	—	1	—
P: Reinstated value	—	—	1	—	—	—
Q: Assigned value with additions at cost	1	4	2	2	2	—
R: Estimated realizable or recoverable value or less	3	1	3	—	—	—
S: Nominal value	2	5	10	1	3	—
T: At "No Value"	3	1	2	—	—	—
U: Acquisition value	—	—	1	—	—	—
V: Lower of cost or equity	1	—	—	—	—	1
W: Less reserve to nominal value	1	—	1	—	—	—
Total	239	174	185	175	144	115
Basis of valuation not set forth	44	63	51	28	37	22
Less reserve—(basis of valuation not set forth)	2	3	8	4	3	9
Total	285	240	244	207	184	146
Number of Companies with Investment Account for:						
Unconsolidated subsidiary companies	266	220	223	—	—	—
Affiliated companies	—	—	—	204	173	144
Account not presented	334	380	377	396	427	456
Total	600	600	600	600	600	600

Refer to Company Appendix Section—

I: *Unconsolidated Subsidiaries*—A: Co. Nos. 34, 158, 237, 381, 436, 584; B: Co. Nos. 126, 190, 255, 325, 472, 560; C: Co. Nos. 46, 172, 287, 326, 457, 585; D: Co. Nos. 90, 128, 252, 389, 541, 574; E: Co. Nos. 92, 183; F: Co. No. 495; H: Co. Nos. 49, 402; I: Co. No. 208; J: Co. Nos. 63, 203; K: Co. Nos. 105, 143, 229, 308, 471, 579; L: Co. Nos. 129, 304, 437; M: Co. Nos. 110, 394; O: Co. No. 419; Q: Co. No. 420; R: Co. Nos. 502, 514, 588; S: Co. Nos. 237, 563; T: Co. Nos. 21, 179, 349; V: Co. No. 105; W: Co. No. 189.

II: *Affiliated Companies*—A: Co. Nos. 25, 142, 256, 360, 430, 500; B: Co. Nos. 158, 242, 274, 357, 397, 553; C: Co. Nos. 63, 120, 159, 316, 446, 552; D: Co. Nos. 137, 248, 342, 469, 536; E: Co. No. 92; H: Co. No. 402; K: Co. No. 203; M: Co. No. 110; Q: Co. Nos. 279, 431; S: Co. No. 130.

TABLE 17: ADDITIONAL STATEMENTS COVERED BY AUDITORS' REPORTS

Statements Applicable To:	1960	1959	1955	1950
A: Reporting Company				
Statement of working capital, source and application of funds (*Co. Nos. 7, 26, 90, 177, 239, 308, 326, 432, 514, 588) ..	30	26	21	13
Capital surplus statement (*Co. Nos. 11, 145, 401, 439, 591) ..	22	18	2	—
Balance sheet (*Co. Nos. 110, 128, 574) ..	5	5	9	7
Income statement (*Co. Nos. 22, 112, 577) ..	5	4	9	4
Stockholders' equity statement (*Co. Nos. 370, 397, 489, 519)	9	7	1	1
Financial operating data (*Co. Nos. 48, 200, 221, 443, 516) ..	10	6	11	6
Pro forma statement (*Co. Nos. 72, 220, 473) ..	4	2	—	—
Employee bonus—retirement or welfare funds (*Co. Nos. 92, 93, 356, 464, 569) ..	5	5	4	8
Geographical statement (*Co. Nos. 172, 208, 259, 505, 519) ..	8	5	6	4
Branch store—investment ..	—	—	—	2
Long-term indebtedness ..	—	2	1	—
Retained earnings statement ..	—	1	1	—
Combined income & retained earnings (*Co. No. 594)	1	—	—	1
Miscellaneous ..	—	—	3	—
B: Parent Company				
Balance sheet (*Co. No. 504) ..	1	1	2	4
Income statement (*Co. No. 504) ..	1	1	2	3
Retained earnings statement ..	—	—	1	1
Capital surplus statement ..	—	—	1	1
Stockholders' equity statement (*Co. No. 504) ..	1	1	1	1
C: Domestic Subsidiary				
Balance Sheet (*Co. Nos. 1, 10, 105, 127, 134, 193) ..	29	25	12	13
Combined income and retained earnings (*Co. Nos. 69, 128, 193, 250, 256, 571) ..	11	12	5	4
Income statement (*Co. Nos. 363, 489) ..	3	1	2	6
Retained earnings (*Co. No. 121) ..	2	—	—	3
Financial data (*Co. No. 308) ..	1	—	—	—
Shareholders' investment ..	—	—	1	—
D: Foreign Subsidiary				
Balance sheet (*Co. Nos. 37, 312, 351, 473, 593, 595)	10	7	9	10
Assets and liabilities (*Co. Nos. 2, 509, 585) ..	6	6	1	2
Combined income and retained earnings (*Co. Nos. 312, 593) ..	2	3	4	3
Income statement (*Co. Nos. 317, 351, 473, 515, 595)	6	2	4	6
Retained earnings statement (*Co. Nos. 259, 473) ..	2	1	—	1
Financial data (*Co. Nos. 27, 33, 250, 345) ..	4	5	1	3
Minority interests (*Co. No. 266) ..	1	1	—	1
Long-term indebtedness (*Co. No. 266) ..	1	1	1	1
E: Affiliated Company				
Balance sheet ..	—	1	—	1
Income statement (*Co. No. 223) ..	1	—	—	—
Total ..	<u>181</u>	<u>149</u>	<u>115</u>	<u>110</u>

Year	Number of Companies Presenting Additional Statements					Number of Companies With:		Total
	Type A	Type B	Type C	Type D	Type E	Additional statements	No additional statements	
1960:	85	1	29	22	1	127	473	600
1959:	65	1	25	20	1	102	498	600
1955:	51	2	11	13	—	71	529	600
1950:	38	3	13	14	1	64	536	600

Comparative Presentation of Additional Statements									Grand Total
Year	2 Yrs.	3 Yrs.	4 Yrs.	5 Yrs.	6-7 Yrs.	8-9 Yrs.	10-11 Yrs.	Total	
1960:	89	—	3	—	2	—	16	110	181
1959:	68	1	3	—	—	—	10	82	149
1955:	58	1	4	—	2	—	12	77	115
1950:	45	1	1	2	—	2	6	57	110

*Refer to Company Appendix Section.

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