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ISSUES PAPER

June 3, 1980
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Accounting in Consolidation for Issuances of a Subsidiary's Stock

Prepared by
Task Force on Consolidation Problems
Accounting Standards Division
American Institute of Certified Public Accountants

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INTRODUCTION

1. This issues paper discusses accounting in consolidation for issuances of a subsidiary's stock that cause changes in the parent's ownership percentage in the subsidiary. The issues raised in this paper also apply to conversions into common shares of a subsidiary's debt or preferred stock and to exchanges of a subsidiary's shares for shares or assets of another entity in which the parent wants to take a position.

2. A parent's ownership percentage in a subsidiary changes when:

   a. the parent buys additional shares of the subsidiary's stock.

   b. the parent sells shares of the subsidiary's stock.

   c. the subsidiary reacquires shares of its stock.

   d. the subsidiary issues shares of its stock

The literature and predominant accounting practice for each of the four situations are summarized as follows.

	buys (reaquires) shares of the subsidiary's stock	sells (issues) shares of the subsidiary's stock
The parent	(a) APB Opinion 16 applies; the acquisition is accounted for by the purchase method (paragraph 43); the difference between the parent's cost and its proportional share of the subsidiary's fair values of tangible and identifiable intangibles less liabilities is recorded as goodwill (paragraph 68).	(b) Paragraph 19f of APB Opinion 18 appears to be consistently applied; the sale is accounted for as a gain or loss equal to the difference between the selling price and the carrying amount of the stock sold. Therefore, the above is not raised as an issue in this paper.
The subsidiary	(c) APB Opinion 16 applies according to a December 1971 AICPA interpretation, which specifies that the acquisition of some or all of the stock held by minority interest--whether acquired by the parent, <u>the subsidiary</u>, or another affiliate--should be accounted for by the purchase method (emphasis added).	(d) ? Neither APB Opinion 18 nor other authoritative literature specifically covers this. Possible accounting treatments include: • recognizing gains and losses. • recognizing adjustments to paid in capital. • crediting all proceeds to minority interest.[1]

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[1] The theory underlying this view is that, in consolidation, only majority shareholders contribute to majority shareholders' equity. Transactions in a subsidiary's stock involving parties other than the parent should therefore result in contributions to the minority's interest. This view is believed to have neither wide acceptance nor significant application in practice and, accordingly, is not dealt with in this paper.

3. The division believes either literature is clear or practice is consistent for situations (a), (b), and (c), but asks the Board to consider the issues raised in this paper for situation (d) to clarify the literature.

RELEVANT ACCOUNTING LITERATURE

4. The following accounting literature was found relevant to this paper. (Also see section on "Discussions in Accounting Books" beginning in paragraph 10 .)

	Date Issued
APB Opinion 16, "Business Combinations," paragraph 43	8/70
APB Opinion 18, "Equity Method of Accounting for Investments in Common Stock," paragraphs 19d, 19e, and 19f	3/71
Accounting Interpretation of APB Opinion 16, "Acquisition of Minority Interest"	12/71
Handbook of the Canadian Institute of Chartered Accountants, sections 1600.47 and 1600.48	4/75

APB Opinion 16

5. APB Opinion 16, "Business Combinations," paragraph 43 states that"the acquisition...of some or all of the stock held by minority stockholders of a subsidiary - whether acquired by the parent, the subsidiary itself, or another affiliate - should be accounted for by the purchase method... "

Interpretation of APB Opinion 16

6. A December 1971 AICPA interpretation of paragraph 43 of APB Opinion 16, "Acquisition of Minority Interest," states that purchase accounting applies when (a) a parent issues some of its common stock or exchanges assets or debt for some or all of the common stock held by minority shareholders of its subsidiary, (b) the subsidiary reacquires as treasury stock some or all of

the common stock held by minority shareholders, or (c) another subsidiary of the parent issues some of its common stock or exchanges assets or debt for some or all of the common stock held by the minority shareholders of an affiliated subsidiary.

APB Opinion 18

7. Paragraphs 19d and 19e of APB Opinion 18, "Equity Method of Accounting for Investments in Common Stock," discuss the manner in which investee transactions should be reported in financial statements.

> 19d. The investor's share of extraordinary items and its share of prior-period adjustments reported in the financial statements of the investee in accordance with (APB Opinion No. 30) should be classified in a similar manner unless they are immaterial in the income statement of the investor. /As amended/
>
> 19e. A transaction of an investee of a capital nature that affects the investor's share of stockholders' equity of the investee should be accounted for as if the investee were a consolidated subsidiary.

Paragraph 19f of that Opinion states that sales of stock of an investee by an investor should be accounted for as gains or losses equal to the difference at the time of sale between selling price and carrying amount of the stock sold.

Canadian Institute of Chartered Accountants

8. The Handbook of the Canadian Institute of Chartered Accountants, sections 1600.47 and 1600.48, contains specific guidance:

> When a subsidiary company issues shares to interests outside the consolidated group, the effect of the change in the parent's interest as a result of the share issue should enter into determination of consolidated net income.
>
> When a subsidiary acquires its own shares for cancellation from outside interests, the proportionate interest of the parent company after the transaction is increased. Since the transaction is similar in effect to the situation where the parent company acquires an additional interest in a subsidiary it may be accounted for in the same manner as step-by-step acquisitions.

Securities and Exchange Commission

9. The Securities and Exchange Commission has no published guidelines on whether consolidated statements should recognize differences resulting from transactions by a subsidiary in its stock as gains and losses or whether the differences should be treated as adjustments to paid in capital. However, in financial statements filed with it since 1965, the SEC has required that if such differences are increases, they should be recognized in consolidation as credits to paid in capital rather than as gains. The SEC apparently has no guidelines, published or unpublished, for accounting in consolidation for issuances of a subsidiary's stock that cause a decrease in the parent's equity in the subsidiary.

DISCUSSIONS IN ACCOUNTING BOOKS

10. A survey of accounting books shows a diversity of views on the various accounting alternatives. The following summarizes the recommendations in the books surveyed.

11. Finney and Miller, Principles of Accounting-Advanced, Prentice Hall, Inc., 1971, page 176.

> Although the decrease is an unfavorable development, it does not follow that from a consolidated viewpoint the combined entity has suffered a loss or incurred an expense. As a result of the capital-raising transaction of the subsidiary, a portion of the subsidiary's stockholders' equity has "shifted" to the minority interest. Because the origin of the change is a capital-transaction, it seems appropriate to assign the reduction in the parent's equity to the parent's paid-in capital, to the extent that its balance can absorb the reduction. If the parent has insufficient or no paid-in capital, its retained earnings should be debited.

12. Griffin, Williams, and Larson, Advanced Accounting Richard D. Irwin, Inc., 1977, pages 329 to 334.

> Subsidiary Transactions of a Capital Nature
>
> Because the economic substance of this class of transactions is equivalent from the parent company's point of view, the change in equity should be recognized in a consistent manner. Accordingly, when the transaction increases the proportionate ownership interest of the parent company, the ownership change is analogous to a purchase from third parties and a net change in equity should be treated as an adjustment of the previously existing unamortized differential. When the transaction decreases the parent's proportionate ownership interest, it is analagous to a sale to third parties and the net change in equity should be recognized as a gain or loss of the period.

13. Fisher, Taylor, and Leer, Advanced Accounting, South Western Publishing Co., 1978, pages 417 to 424.

Sale of Subsidiary Stock

From a consolidated viewpoint, such apparent gain or loss is a result of transactions between the consolidated group and its shareholders. On this basis, such gains are treated as additional paid in capital of the parent. Losses are an offset to paid in capital, unless none exists, in which case the loss is removed from the parent's retained earnings.

14. Floyd A. Beams, Advanced Accounting, Prentice Hall, Inc., 1979, pages 306 to 308.

Changes in Ownership Interest

The parent's increased equity in a subsidiary's stock issuance is a direct equity adjustment and should not be considered a gain to the parent. Similarly a decrease in underlying equity from the sale of stock by a subsidiary to outsiders should be charged to additional paid in capital and should not be considered a loss.

15. Defliese, Johnson, and Macleod, Montgomery's Auditing, Ronald Press Company, 1975, pages 697 and 698.

Changes in Parent's Interest in Subsidiary

The increase (or decrease) requires adjustment of the relative interests of the parent company and the minority stockholders when the subsidiary's assets are carried into the consolidation. Some have argued that the parent might record a gain or loss to reflect the change in carrying value of its investment in the subsidiary, but in practice the transaction is reflected as a direct charge or credit to stockholders' equity, usually additional paid-in capital. The SEC has insisted that credits resulting from a subsidiary's issue of its shares to outsiders must be excluded from income.

> Depending on the original purchase price, whether goodwill resulted at the time of acquisition, the parent's percentage of ownership reduction, and related factors, the mechanical computations for that kind of transaction can become quite complex. In our opinion, different accounting treatment for transactions that differ in form but not in substance appear anomalous.

16. Watt, Hammer, and Burge, Accounting for the Multinational Corporation, Financial Executive Research Foundation, Inc., 1977, page 247.

> Changes in Interest
>
> In such cases (investee's own stock transactions) an increase in an investor's percentage ownership interest is an investee, say from 70% to 80%, should be viewed as simply creating a new average cost per share of the investment and that a decrease of interest should be considered a sale developing a profit or loss just as surely as a sale by the investor of shares to third parties is generally accepted as developing a profit or loss.

SURVEY OF PRACTICE

17. The following note taken from an annual report illustrates the accounting by a public company in which a subsidiary has issued common shares.

Bolt, Beranik and Newman, Inc.
June 30, 1979

Note on Long Term Investments:

> As a result of the two public offerings of Telenet stock (a subsidiary), BBN's "Investment in Telenet" account was increased by an aggregate $2,150,000, in addition to the $1,103,800 paid for the shares purchased in the December 1977 financing. Correspondingly, BBN's shareholders' equity was increased by $2,150,000,

recorded as "Capital surplus arising from Telenet capital transactions." The amount represented the increase in BBN's share of Telenet's net worth as a result of the two public offerings.

18. Although the financial statements of nonpublic companies are generally unavailable for public distribution, the division is unaware of any significant practice by nonpublic companies that differs from the SEC position concerning accounting in consolidation for issuances of a subsidiary's stock.

ISSUES

Basic Issue

19. The basic issue is how issuances of a subsidiary's stock other than to the parent that cause a change in its parent's ownership percentage in the subsidiary should be accounted for in consolidation.

Economic Differences

20. Some believe that changes in a parent's ownership percentage in a subsidiary caused by issuances of the subsidiary's stock should be recognized in consolidation as gains or losses (that is, accounted for as if the parent sold its shares of the subsidiary's stock). They argue that although the transactions differ in form, they do not differ in substance and therefore the accounting in consolidation should be the same. Others believe that the economic differences (discussed below) between a subsidiary issuing shares of its stock and its parent selling shares of the subsidiary's stock are significant enough to warrant different accounting treatment. Consequently, they

believe such changes in the parent's ownership percentage in the subsidiary should be recognized as adjustments to paid in capital in consolidation. They believe the economic differences include:

1. Culmination of the Earnings Process. The earnings process for the parent is not culminated when a subsidiary issues additional stock to outsiders, but it is when a parent sells its shares of stock in the subsidiary. Also, the consideration realized by a parent from the sale of its shares of a subsidiary's stock belongs to the parent, and may be used however the parent wants. The consideration realized by a subsidiary from the issuance of its own stock belongs not to the parent but to the subsidiary.

2. Disposition of Investment. When a parent sells some of its shares of a subsidiary's stock to outsiders, it disposes of part of its investment. However, when a subsidiary issues additional shares of its stock to outsiders, the subsidiary's net worth expands and the parent retains its investment. The parent merely has a smaller percentage of a larger entity than before the issuance.

3. Tax Consequences. A parent's sale at a gain of its shares of a subsidiary's stock to outsiders is

usually taxable. However, no taxes are payable when a subsidiary issues shares of its own stock to outsiders. Consequently, to have the same amount of consideration available after taxes, a larger amount of consideration would be required in a transaction in which the parent sells its shares of a subsidiary's stock to outsiders at a taxable gain than in a transaction in which the subsidiary issues additional shares of its stock. Even if the same amount of consideration before taxes is involved in each transaction, the amount of cash (or other consideration received), income taxes payable, and income tax expense would, because of the different income tax consequences, differ in consolidation depending on whether the parent or the subsidiary was a party to the transaction.

4. Different Percentage of Ownership. A different percentage of ownership remains with the parent following a sale or issuance of the same number of shares of a subsidiary's stock depending on whether the parent sells the stock or the subsidiary issues the stock.

5. Different Number of Shares. A different number of shares remains with the parent following the sale or issuance of a subsidiary's stock that provides

outsiders with the same percentage of ownership depending on whether the parent sells the stock or the subsidiary issues the stock.

The following exhibit illustrates the economic differences identified. S is a company with 2000 shares of stock authorized and 1000 shares issued, and P owns 100% of S.

Parent's Records	Subsidiary's Records
P sells 250 of its shares in S. The sales price is $20 a share and the carrying amount is $15 a share. *	S issues to outsiders 250 shares of its stock for $20 a share.
Cash Received $5000 (250 shares @ $20) Investment in S 3750 (250 shares @ $15) Gain $1250	Cash Received $5000 (250 shares @ $20) Capital Stock $5000
**1. The earnings process for P is culminated for the shares sold. Also, the cash realized by P belongs to P and may be used by P however it wants.	1. The earnings process for P is not culminated. Also, the cash realized by S belongs, not to P, but to S.
2. P has disposed of 250 shares of its investment in S.	2. S has issued 250 shares of its own stock. P has disposed of nothing.
3. The $5000 proceeds realized by P are assumed to be at least partially taxable, so P has in effect realized after taxes not $5000, but a lesser amount.	3. This is not a taxable event.
4. & 5. In disposing of 250 of its shares of S stock, P now owns 75% of S (750/1000 shares of S). S is still a subsidiary of P.	4. & 5. As a result of S issuing to outsiders 250 of its own shares, P now owns 80% of S (1000/1250 shares of S), P retains its investment but now owns a smaller percentage of a larger entity than before the issuance. S is still a subsidiary of P.

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* The accounting would be the same if the investment were carried on the equity method.

** These numbers refer to the numbered economic differences in paragraph 20.

Summary of Arguments

21. Those who believe changes in the parent's ownership percentage in a subsidiary caused by issuances of the subsidiary's stock should be recognized in consolidation as adjustments of paid in capital have these reasons:

- The economic differences between a parent selling its subsidiary's stock and the subsidiary issuing its stock are significant enough to warrant different accounting treatment in consolidation.
- When the subsidiary issues its stock, from a consolidated viewpoint, there is simply a reallocation of the subsidiary's stockholders equity to a minority interest. Since the reallocation results from a capital transaction, the effect should be accounted for as as an adjustment of paid in capital.

22. Those who believe changes in the parent's ownership percentage in a subsidiary caused by issuances of the subsidiary's stock should be recognized in consolidation as gains or losses have these reasons:

- The economic differences between a parent selling its subsidiary's stock and the subsidiary issuing its stock are not significant enough to warrant different accounting treatment in consolidation.

- A parent's ownership percentage in the subsidiary can change whether the parent sells its subsidiary's stock or the subsidiary issues its stock. A parent should not be able to choose alternative accounting treatments simply by designating the subsidiary instead of itself to be the party to the transaction.
- Subsidiary capital transactions should not give rise to consolidated paid in capital because outside investors in subsidiaries are not investors of the consolidated group.

Collateral Issue Related to Gain or Loss

23. If changes in a parent's ownership percentage in a subsidiary caused by issuances of the subsidiary's stock should be recognized in consolidation as gains or losses, the next issue is whether tax effect accounting should be applied to the gain or loss.

24. APB Opinions 23 and 24, "Accounting for Income Taxes--Special Areas," discuss situations in which deferred income taxes should not be provided on undistributed earnings of subsidiaries. Some believe the principles set forth in those Opinions should also apply to changes of a parent's investment in a subsidiary caused by subsidiary capital transactions. Others believe those Opinions should not apply.

Collateral Issue Related to Capital Transaction

25. If changes in a parent's ownership percentage in a subsidiary caused by issuances of the subsidiary's stock should be recognized in consolidation as adjustments to paid in capital, the next issue is whether there are circumstances in which that treatment would be inappropriate.

26. Some believe decreases in the parent's ownership percentage in a subsidiary should always be recognized as charges to paid in capital in consolidation because the transactions causing the decreases are capital transactions.

27. Others believe such decreases in the parent's ownership percentage in a subsidiary indicate that the carrying amount of the underlying assets of the subsidiary should be written down by a charge to income in consolidation.

28. Still others believe there are circumstances in which such decreases in the parent's ownership percentage in the subsidiary should be charged to paid in capital, but that in other circumstances pervasive evidence may exist that it is probable that the parent will be unable to fully recover the carrying amount of its investment in the subsidiary and in those circumstances the carrying amount of the underlying assets of the subsidiary should be written down by a charge to income in consolidation.[2]

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[2] The accounting standards division is currently developing a paper that discusses issues relating to the inability to fully recover the carrying amount of long lived assets.

Investor-Investee Relationships

29. The issues raised in this paper are primarily discussed in terms of parent and subsidiary transactions. Some believe the issues apply to all investor-investee relationships accounted for by the equity method because paragraph 19 of APB Opinion 18 says that "an investor's net income for the period and its stockholders' equity at the end of the period are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated." Others believe the issues only apply to investor-investee relationshops in which the investor has the ability to exercise control over the investee, generally as evidenced by a majority ownership of stock.

*　　*　　*　　*　　*

ADVISORY CONCLUSIONS

30. These are the advisory conclusions of the Accounting Standards Executive Committee and its Task Force on Consolidation Problems concerning the issues raised in this paper:

a. Changes in a parent's ownership percentage in a subsidiary caused by issuances of the subsidary's stock should be recognized in consolidation as gains or losses.

AcSEC: 10 yes, 5 no

Task Force: 5 yes, 2 no

b. If changes in a parent's ownership percentage in a subsidiary caused by issuances of the subsidiary's stock should be recognized in consolidation as gains or losses, tax effect accounting should be applied to the gain or loss.

AcSEC: 13 yes, 1 no, 1 abstention

Task Force: 6 yes, 1 no