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Accounting Research BULLETINS

October, 1954

No. 44

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Issued by the
Committee on Accounting Procedure,
American Institute of Accountants,
270 Madison Avenue, New York 16, N.Y.

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Declining-balance Depreciation

1. The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income-tax purposes in the Internal Revenue Code of 1954.

2. The declining-balance method is one of those which meets the requirements of being "systematic and rational."¹ In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conclusions of this bulletin also apply to other methods, including the "sum-of-the-years-digits" method, which produce substantially similar results.

3. When a change to the declining-balance method is made for general accounting purposes, and depreciation is a significant factor in the determination of net income, the change in method, including the effect thereof, should be disclosed in the year in which the change is made.

4. There may be situations in which the declining-balance method is adopted for tax purposes but other appropriate methods are followed for financial accounting purposes. In such cases it may be that accounting recognition should be given to deferred income taxes. However, the committee is of the opinion that, in the ordinary situation, deferred income taxes need not be recognized in the accounts unless it is reasonably certain that the reduction in taxes during the earlier years of use of the declining-balance method for tax purposes is merely a deferment of income taxes until a relatively few years later, and then only if the amounts are clearly material.

The statement entitled "Declining-balance Depreciation" was adopted by the assenting votes of nineteen members of the committee, of whom one, Mr. Stans, assented with qualification. Mr. Burns dissented.

¹ *Accounting Terminology Bulletin* No. 1, paragraph 56.

Mr. Stans does not approve the conclusions in the last sentence of paragraph 4. He believes that the reductions in taxes in the earlier years of use in the situations described clearly represent deferments of payment until later years and that the number of years involved has no bearing on the problem. He believes that well-established accounting principles require that deferred income taxes be recognized in every case in which the amounts involved are significant.

Mr. Burns dissents because he believes that the reductions in taxes in the earlier years of use in all cases would clearly represent deferments of payment until later years and that the number of years involved has no bearing on the problem. He believes that compliance with well-established accounting principles requires that deferred income taxes be recognized in every case in which a significant amount is involved in order to avoid a misstatement of reported net income, and he believes that the bulletin should contain a definite statement to that effect.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

1. *Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.*

2. *Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.*

3. *It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.*

COMMITTEE ON ACCOUNTING PROCEDURE (1953-1954)

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Accounting Research BULLETINS

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Issued by the
Committee on Accounting Procedure
American Institute of
Certified Public Accountants
270 Madison Avenue, New York 16, N. Y.
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July, 1958

No. 44
(Revised)

**Declining-balance
Depreciation**
(Supersedes Accounting Research
Bulletin No. 44 issued in October 1954)

1. The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income-tax purposes in the Internal Revenue Code of 1954.

2. The declining-balance method is one of those which meets the requirements of being "systematic and rational."¹ In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conclusions of this bulletin also apply to other methods, including the "sum-of-the-years-digits" method, which produce substantially similar results.

3. When a change to the declining-balance method is made for general accounting purposes, and depreciation is a significant factor in the determination of net income, the change in method, including the effect thereof, should be disclosed in the year in which the change is made.

4. There may be situations in which the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes. In such cases, accounting rec-

¹Accounting Terminology Bulletin No. 1, par. 56.

ognition should be given to deferred income taxes if the amounts thereof are material, except in those rare cases, such as are mentioned in paragraph 8, where there are special circumstances which may make such procedure inappropriate. The foregoing provision as to accounting recognition of deferred income taxes applies to a single asset, or to a group of assets which are expected to be retired from service at about the same time; in this case an excess of depreciation taken for income-tax purposes during the earlier years would be followed by the opposite condition in later years, and there would be a tax deferment for a definite period. It applies also to a group of assets consisting of numerous units which may be of differing lengths of life and which are expected to be continually replaced; in this case an excess of depreciation taken for income-tax purposes during the earlier years would be followed in later years by substantial equality between the annual depreciation for income-tax purposes and that for accounting purposes, and a tax deferment would be built up during the earlier years which would tend to remain relatively constant thereafter. It applies further to a gradually expanding plant; in this case an excess of depreciation taken for income-tax purposes may exist each year during the period of expansion in which event there would be a tax deferment which might increase as long as the period of expansion continued.

5. Where it may reasonably be presumed that the accumulative difference between taxable income and financial income will continue for a long or indefinite period, it is alternatively appropriate, instead of crediting a deferred tax account, to recognize the related tax effect as additional amortization or depreciation applicable to such assets in recognition of the loss of future deductibility for income-tax purposes.

DISCUSSION

6. Following the passage of the Internal Revenue Act of 1954 in August of that year, permitting the use of declining-balance and similar accelerated depreciation methods for federal income-tax purposes, the committee anticipated that many companies would be considering whether such methods should be adopted for general accounting purposes. In October of that year, Accounting Research Bulletin No. 44 was issued in which the committee stated that such accelerated methods met the requirement of being "systematic and rational." The

committee also stated that when such methods were adopted for general accounting purposes, appropriate disclosure of the change should be made whenever depreciation was a significant factor in the determination of net income.

7. Since the issuance of Accounting Research Bulletin No. 44, the committee has been observing and studying cases involving the application of the bulletin. Studies of published reports and other source material have indicated that, where material amounts are involved, recognition of deferred income taxes in the general accounts is needed to obtain an equitable matching of costs and revenues and to avoid income distortion, even in those cases in which the payment of taxes is deferred for a relatively long period. This conclusion is borne out by the committee's studies which indicate that where accelerated depreciation methods are used for income-tax purposes only, most companies do give recognition to the resultant deferment of income taxes or, alternatively, recognize the loss of future deductibility for income-tax purposes of the cost of fixed assets by an appropriate credit to an accumulated amortization or depreciation account applicable to such assets.

8. Many regulatory authorities permit recognition of deferred income taxes for accounting and/or rate-making purposes, whereas some do not. The committee believes that they should permit the recognition of deferred income taxes for both purposes. However, where charges for deferred income taxes are not allowed for rate-making purposes, accounting recognition need not be given to the deferment of taxes if it may reasonably be expected that increased future income taxes, resulting from the earlier deduction of declining-balance depreciation for income-tax purposes only, will be allowed in future rate determinations.

9. In those rare situations in which accounting for deferred income taxes is not appropriate, full disclosure should be made of the amount of deferred income taxes arising out of the difference between the financial statements and the tax returns when the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes.

10. The committee believes that, in applying the provisions of this bulletin to cases where there was no accounting recognition of deferred income taxes for the years since 1953, the entries made for periods

subsequent to the issuance of this bulletin should be based upon all assets acquired after 1953 as to which the declining-balance method has been elected for tax purposes. As is indicated in the "Notes" to each Accounting Research Bulletin, opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. If a retroactive adjustment is made for prior periods, the adjustment may be made in a lump sum, or the deficiency may be systematically accumulated over a reasonable future period of time.

The statement entitled "Declining-balance Depreciation" (July 1958) was adopted unanimously by the twenty-one members of the committee, of whom five, Messrs. Burns, Graham, Halvorson, Jennings, and Powell, assented with qualification.

Mr. Burns objects to the exceptions mentioned in paragraph 4 and discussed in paragraphs 8 and 9. He believes that accounting principles apply equally to all companies operated for profit and that the exceptions referred to are wholly inconsistent with the basic principles stated in paragraph 4; further, that the last sentence of paragraph 8 is based upon an untenable concept, namely, that accounting resulting from the application of an accounting rule prescribed by a regulatory commission may properly be approved by public accountants notwithstanding the fact that the rule is clearly contrary to generally accepted accounting principles.

Mr. Graham objects to the exceptions mentioned in the second sentence of paragraph 4 and discussed in the last sentence of paragraph 8 and in paragraph 9. He believes that accepted accounting principles should be applied uniformly to all corporations, including regulated companies. He does not believe that rate-making rules which are in conflict with these accepted principles constitute a sound basis for sanctioning a departure from these principles in financial reporting. Furthermore, he disagrees with the validity of the assumption which, by implication, forms the basis for this exception; he does not believe that public utility rates will always be adjusted automatically to compensate fully, or even substantially, for increases in future income taxes; he believes that this assumption is not in accord with the known realities of rate regulation and is not, therefore, a proper basis for the anticipation of future revenues.

Mr. Halvorson dissents from the recommendations of paragraph 4 because he believes its requirements for accounting recognition of deferred income taxes should be limited to a requirement for compliance with the recommendations of chapter 10(b) of Accounting Research Bulletin No. 43; he believes that paragraph 4 is effectively a revision of chapter 10(b) and that it is improper thus to make a substantive change in the committee's existing recommendations for tax allocation in the guise of a revision of a bulletin on depreciation.

Messrs. Jennings and Powell dissent from the conclusion (expressed in paragraph 4 and implied in the related discussion) that where the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes, there should be accounting recognition of deferred income taxes, except for certain rare cases. They believe this calls for more extensive allocation of income taxes among periods of time than is necessary or desirable, especially where the situation is such that the so-called tax deferment is in effect a permanent tax reduction. Further, they object to the use of a bulletin on depreciation incidentally as a vehicle for making an important change in the committee's views, as set forth in previous bulletins, on accounting for income taxes.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee, the technical services department, and the director of research. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of

the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

COMMITTEE ON ACCOUNTING PROCEDURE (1957-58)

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—
CARMAN G. BLOUGH
Director of Research



American Institute of Certified Public Accountants

270 MADISON AVENUE, NEW YORK 16, N. Y.

April 15, 1959

TO THE MEMBERS OF THE AMERICAN INSTITUTE
OF CERTIFIED PUBLIC ACCOUNTANTS

GENTLEMEN:

Question has been raised with respect to the intent of the committee on accounting procedure in using the phrase "a deferred tax account" in Accounting Research Bulletin No. 44 (revised), *Declining-balance Depreciation*, to indicate the account to be credited for the amount of the deferred income tax (see paragraphs 4 and 5).

The committee used the phrase in its ordinary connotation of an account to be shown in the balance sheet as a liability or a deferred credit. A provision in recognition of the deferral of income taxes, being required for the proper determination of net income, should not at the same time result in a credit to earned surplus or to any other account included in the stockholders' equity section of the balance sheet.

Three of the twenty-one members of the committee, Messrs. Jennings, Powell and Staub, dissented to the issuance at this time of any letter interpreting Accounting Research Bulletin No. 44 (revised).

COMMITTEE ON ACCOUNTING PROCEDURE

By WILLIAM W. WERNTZ, *Chairman*

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Director of Research

Accounting Research BULLETINS

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Issued by the
Committee on Accounting Procedure
American Institute of
Certified Public Accountants
270 Madison Avenue, New York 16, N. Y.

October, 1955

No. 45

Long-term Construction-type Contracts

1. This bulletin is directed to the accounting problems in relation to construction-type contracts in the case of commercial organizations engaged wholly or partly in the contracting business. It does not deal with cost-plus-fixed-fee contracts, which are discussed in Chapter 11, Section A, of Accounting Research Bulletin No. 43*, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered. In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, the bulletin would also be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant. The problems in accounting for construction-type contracts arise particularly in connection with long-term contracts as compared with those requiring relatively short periods for completion.

2. Considerations other than those acceptable as a basis for the recognition of income frequently enter into the determination of the

**Restatement and Revision of Accounting Research Bulletins*, American Institute of Accountants, 1953.

timing and amounts of interim billings on construction-type contracts. For this reason, income to be recognized on such contracts at the various stages of performance ordinarily should not be measured by interim billings.

GENERALLY ACCEPTED METHODS

3. Two accounting methods commonly followed by contractors are the percentage-of-completion method and the completed-contract method.

Percentage-of-completion Method

4. The percentage-of-completion method recognizes income as work on a contract progresses. The committee recommends that the recognized income be that percentage of estimated total income, either:

- (a) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or
- (b) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income.

5. Under this method current assets may include costs and recognized income not yet billed, with respect to certain contracts; and

liabilities, in most cases current liabilities, may include billings in excess of costs and recognized income with respect to other contracts.

6. When the current estimate of total contract costs indicates a loss, in most circumstances provision should be made for the loss on the entire contract. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss.

7. The principal advantages of the percentage-of-completion method are periodic recognition of income currently rather than irregularly as contracts are completed, and the reflection of the status of the uncompleted contracts provided through the current estimates of costs to complete or of progress toward completion.

8. The principal disadvantage of the percentage-of-completion method is that it is necessarily dependent upon estimates of ultimate costs and consequently of currently accruing income, which are subject to the uncertainties frequently inherent in long-term contracts.

Completed-contract Method

9. The completed-contract method recognizes income only when the contract is completed, or substantially so. Accordingly, costs of contracts in process and current billings are accumulated but there are no interim charges or credits to income other than provisions for losses. A contract may be regarded as substantially completed if remaining costs are not significant in amount.

10. When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract

costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed. It is not so important, however, when the contractor is engaged in numerous projects and in such circumstances it may be preferable to charge those expenses as incurred to periodic income. In any case there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

11. Although the completed-contract method does not permit the recording of any income prior to completion, provision should be made for expected losses in accordance with the well established practice of making provision for foreseeable losses. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for losses.

12. When the completed-contract method is used, an excess of accumulated costs over related billings should be shown in the balance sheet as a current asset, and an excess of accumulated billings over related costs should be shown among the liabilities, in most cases as a current liability. If costs exceed billings on some contracts, and billings exceed costs on others, the contracts should ordinarily be segregated so that the figures on the asset side include only those contracts on which costs exceed billings, and those on the liability side include only those on which billings exceed costs. It is suggested that the asset item be described as "costs of uncompleted contracts in excess of related billings" rather than as "inventory" or "work in process," and that the item on the liability side be described as "billings on uncompleted contracts in excess of related costs."

13. The principal advantage of the completed-contract method is that it is based on results as finally determined, rather than on estimates for unperformed work which may involve unforeseen costs and possible losses.

14. The principal disadvantage of the completed-contract method is that it does not reflect current performance when the period of any contract extends into more than one accounting period and under such circumstances it may result in irregular recognition of income.

Selection of Method

15. The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable. Disclosure of the method followed should be made.

COMMITMENTS

16. In special cases disclosures of extraordinary commitments may be required, but generally commitments to complete contracts in process are in the ordinary course of a contractor's business and are not required to be disclosed in a statement of financial position. They partake of the nature of a contractor's business, and generally do not represent a prospective drain on his cash resources since they will be financed by current billings.

The statement entitled "Long-term Construction-type Contracts" was adopted unanimously by the twenty-one members of the committee, of whom two, Mr. Coleman and Mr. Dixon, assented with qualification.

Mr. Coleman and Mr. Dixon do not approve the statements in paragraphs 6 and 11 as to provisions for expected losses on contracts. They believe that such provisions should be made in the form of footnote disclosure or as a reservation of retained earnings, rather than by a charge against revenues of the current period.

Mr. Coleman also questions the usefulness of the refinement of segregating the offset costs and billings by character of excess as set forth in the second sentence of paragraph 12. He suggests that a more useful alternative would be to show in any event total costs and total billings on all uncompleted contracts (a) with the excess shown either as a current asset or a current liability, and (b) with a supporting schedule indicating individual contract costs, billings, and explanatory comment.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

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2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be

considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

COMMITTEE ON ACCOUNTING PROCEDURE (1954-1955)

JOHN A. LINDQUIST, Chairman
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Director of Research

**Accounting Research
BULLETINS**

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Issued by the
Committee on Accounting Procedure
American Institute of
Certified Public Accountants
270 Madison Avenue, New York 16, N. Y.

February, 1956

No. 46

**Discontinuance of
Dating Earned Surplus**

1. Paragraph 10 of Chapter 7(a), *Quasi-Reorganization or Corporate Readjustment*, of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, reads as follows:

After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

2. The committee believes that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. It also believes that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years.

The statement entitled "Discontinuance of Dating Earned Surplus" was adopted by the assenting votes

of twenty members of the committee. One member, Mr. Keating, did not vote.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

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3. *It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.*

COMMITTEE ON ACCOUNTING PROCEDURE (1955-1956)

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September, 1956

No. 47

Accounting for Costs of Pension Plans

1. Variations in the provisions of pension plans in the United States, in their financial arrangements, and in the circumstances attendant upon their adoption, have resulted in substantial differences in accounting for pension costs. This bulletin indicates guides which, in the opinion of the committee, are acceptable for dealing with costs of pension plans in the accounts and reports of companies having such plans. It is not concerned with funding as such.

2. The term *pension plan* is here intended to mean a formal arrangement for employee retirement benefits, whether established unilaterally or through negotiation, by which commitments, specific or implied, have been made which can be used as the basis for estimating costs. It does not include profit-sharing plans or deferred-compensation contracts with individuals. It does not apply to informal arrangements by which voluntary payments are made to retired employees, usually in amounts fixed at or about the time of an employee's retirement and in the light of his then situation but subject to change or discontinuance at the employer's will; where such informal arrangements exist, the pay-as-you-go method of accounting for pension costs generally is appropriate, although the accrual method is equally appropriate in cases where costs can be estimated with reasonable accuracy.

3. When a pension plan is first adopted, it is customary to provide that pensions for covered employees will give recognition not only to services which are to be rendered by them in the future, but also to services which have been rendered by them prior to the adoption of the plan. The costs of the pensions to the employer, therefore, usually are based in part on past services and in part on current and future services of the employees. The committee considers that all of such costs are costs of doing business, incurred in contemplation of present and future benefits, as are other employment costs such as wages, salaries, and social security taxes. It, therefore, is of the opinion that past service benefit costs should be charged to operations during the current and future periods benefited, and should not be charged to earned surplus *at the inception of the plan*. The committee believes that, in the case of an *existing plan* under which inadequate charges or no charges for past services have been made thus far and the company has decided to conform its accounting to the preferred procedure expressed in this bulletin, it may be appropriate to charge to earned surplus the amount that should have been accumulated by charges to income since inception of the plan.

4. In addition to the basic features of a pension plan relating to employee eligibility and the level of pension payments, other factors enter into the determination of the ultimate costs of pensions. Some of these are:

- (a) other benefits (such as social security) where amounts of pension payments are integrated therewith;
- (b) length of life of employees both before and after retirement;
- (c) employee turnover;
- (d) in some cases, alternatives as to age at which employees may retire;
- (e) future compensation levels; and
- (f) in a funded plan, future rates of earnings on the fund and the status of fund investments.

Because of these factors, the total cost of the pensions that will be paid ultimately to the present participants in a plan cannot be determined precisely in advance, but, by the use of actuarial techniques, reasonably accurate estimates can be made. There are other business costs for which it is necessary to make periodic provisions in the accounts based upon assumptions and estimates. The committee believes that the uncertainties relating to the determination of pension costs are not so pronounced as to preclude similar treatment.

5. In the view of many, the accrual of costs under a pension plan should not necessarily be dependent on the funding arrangements provided for in the plan or governed by a strict legal interpretation of the obligations under the plan. They feel that because of the widespread adoption of pension plans and their importance as part of compensation structures, a provision for cancellation or the existence of a terminal date for a plan should not be the controlling factor in accounting for pension costs, and that for accounting purposes it is reasonable to assume in most cases that a plan, though modified or renewed (because of terminal dates) from time to time, will continue for an indefinite period. According to this view, costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees, generally upon the basis of actuarial calculations. Such calculations may be made as to each employee, or as to categories of employees (by age, length of service, or rate of pay, for example), or they may be based upon an average of the expected service lives of all covered employees. These calculations, although made primarily for funding purposes, may be used also for accounting purposes. They should, of course, be revised at intervals. Also according to this view, costs based on past services should be charged off over some reasonable period, provided the allocation is made on a systematic and rational basis and does not cause distortion of the operating results in any one year. The length of the period benefited by costs based on past services is subject to considerable difference of opinion. Some think that the benefits accrue principally during the early years of a plan;

others feel that the period primarily benefited approximates the remaining service life of the employees covered by a plan at the time of its adoption; still others believe that the benefits of such costs extend over an indefinite period, possibly the entire life of a plan and its successors, if any. In practice, costs based on past services have in many instances been charged off over a ten- to twelve-year period, or over a fixed longer period such as twenty or thirty years. (The minimum period presently permitted for tax purposes is ten years if the initial past-service cost is immediately paid in full, or about twelve years if one-tenth of the initial past-service cost plus interest is paid each year.)

6. In the view of others, the full accrual of pension costs may be unnecessary. They point out that in some cases accounting for such costs in the manner indicated in paragraph 5 would result, as to a given year or cumulatively or both, in the accrual of costs under a pension plan in amounts differing materially from the payments made under the plan into a pension fund or to retired employees, and in other cases it would require the employer to record pension costs in amounts varying widely from his legal liabilities. They say that a company would in all probability never be called upon to utilize the entire amount of an actuarially calculated full accrual, and that, in the event of liquidation of the business, any amounts accrued with respect to employees who have not at the time acquired vested rights would, except for a voluntary act of grace, revert to the surplus of the company. They also believe that in the case of an unfunded or partially funded plan the accumulation of a substantial accrual would lead to pressure for full funding, possibly to the detriment of the company and its security holders, and that fear of this might deter management from entering into pension arrangements beneficial to employees. They also feel that the method of accounting envisioned in paragraph 5 disregards the probability that future unfavorable changes in a company's economic position undoubtedly would lead to changes in the pension arrangements it would make for its em-

ployees. According to this view, management should have wider discretion in accounting for pension costs, provided there is adequate disclosure as to the method followed.

7. The committee regards the method outlined in paragraph 5 as being the method most likely to effect a reasonable matching of costs and revenues, and therefore considers it to be preferable. However, the committee believes that opinion as to the accounting for pension costs has not yet crystallized sufficiently to make it possible at this time to assure agreement on any one method, and that differences in accounting for pension costs are likely to continue for a time. Accordingly, for the present, the committee believes that, as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trusteed funds or annuity contracts purchased.

8. The committee believes that the costs of many pension plans are so material that the fact of adoption of a plan or an important amendment to it constitutes significant information in financial statements. When a plan involving material costs is adopted, there should be a footnote to the financial statements for the year in which this occurs, stating the important features of the plan, the proposed method of funding or paying, the estimated annual charge to operations, and the basis on which such annual charge is determined. When an existing plan is amended to a material extent, there should be similar disclosure of the pertinent features of the amendment. When there is a change in the accounting procedure which materially affects the results of operations, there should be appropriate indication thereof. If there are costs of material amount based on past or current services for which reasonable provision has not been, or is not being, made in the accounts, appropriate disclosure should be made in a footnote to the financial statements as long as this situation exists.

The statement entitled "Accounting for Costs of Pension Plans" was adopted unanimously by the twenty-one members of the committee, of whom six, Messrs. Flatley, Jennings, Lindquist, Luther, Powell and Staub, assented with qualification.

The six members assenting with qualification object to that part of paragraph 3 which appears to sanction the charging to earned surplus in some circumstances of pension costs based on past service. They believe this to be in conflict with section A of chapter 13 of Accounting Research Bulletin No. 43, in which the committee expresses the opinion that costs of annuities based on past service should not be charged to surplus. They consider the conclusions expressed in chapter 13 to be sound for the reasons therein stated.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

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2. *Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.*

3. *It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure*

from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

COMMITTEE ON ACCOUNTING PROCEDURE (1955-1956)

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Director of Research

Accounting Research BULLETINS

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Issued by the
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270 Madison Avenue, New York 16, N. Y.

January, 1957

No. 48

Business Combinations

(Supersedes chapter 7(c) of
Accounting Research
Bulletin No. 43)

1. Whenever two or more corporations are brought together, or combined, for the purpose of carrying on the previously conducted businesses, the accounting to give effect to the combination will vary depending largely upon whether an important part of the former ownership is eliminated or whether substantially all of it is continued. This bulletin differentiates these two types of combinations, the first of which is designated herein as a *purchase* and the second as a *pooling of interests*, and indicates the nature of the accounting treatment appropriate to each type.

2. For accounting purposes, the distinction between a *purchase* and a *pooling of interests* is to be found in the attendant circumstances rather than in the designation of the transaction according to its legal form (such as a merger, an exchange of shares, a consolidation, or an issuance of stock for assets and businesses), or in the number of corporations which survive or emerge, or in other legal or tax considerations (such as the availability of surplus for dividends).

3. For accounting purposes, a *purchase* may be described as a business combination of two or more corporations in which an im-

portant part of the ownership interests in the acquired corporation or corporations is eliminated or in which other factors requisite to a pooling of interests are not present.

4. 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 interests¹ 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. Such corporation may be one of the constituent corporations or it may be a new corporation. After a pooling of interests, the net assets of all of the constituent corporations will in a large number of cases be held by a single corporation. 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, such as the preservation of tax advantages, the preservation of franchises or other rights, the preservation of the position of outstanding debt securities, or the difficulty or costliness of transferring contracts, leases, or licenses.

5. In determining the extent to which a new ownership or a continuity of old ownership exists in a particular business combination, consideration should be given to attendant circumstances. When the shares of stock that are received by the several owners of one of the predecessor corporations are not substantially in proportion to their

¹ As used in this bulletin, the term "ownership interests" refers basically to common stock, although in some cases the term may also include other classes of stock having senior or preferential rights as well as classes whose rights may be restricted in certain respects.

respective interests in such predecessor, a new ownership or purchase of the predecessor is presumed to result. Similarly, if relative voting rights, as between the constituents, are materially altered through the issuance of senior equity or debt securities having limited or no voting rights, a purchase may be indicated. Likewise, a plan or firm intention and understanding to retire a substantial part of the capital stock issued to the owners of one or more of the constituent corporations, or substantial changes in ownership occurring shortly before or planned to occur shortly after the combination, tends to indicate that the combination is a purchase. However, where a constituent corporation has had two or more classes of stock outstanding prior to the origin of the plan of combination, the redemption, retirement, or conversion of a class or classes of stock having senior or preferential rights as to assets and dividends need not prevent the combination from being considered to be a pooling of interests.

6. Other attendant circumstances should also be taken into consideration in determining whether a purchase or a pooling of interests is involved. Since the assumption underlying the pooling-of-interests concept is one of continuity of all of the constituents in one business enterprise, abandonment or sale of a large part of the business of one or more of the constituents militates against considering the combination as a pooling of interests. Similarly, the continuity of management or the power to control management is involved. Thus, if the management of one of the constituents is eliminated or its influence upon the over-all management of the enterprise is very small, a purchase may be indicated. Relative size of the constituents may not necessarily be determinative, especially where the smaller corporation contributes desired management personnel; however, where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90% to 95% or more of the voting interest in the combined enterprise), there is a pre-

sumption that the transaction is a purchase rather than a pooling of interests.

7. No one of the factors discussed in paragraphs 5 and 6 would necessarily be determinative and any one factor might have varying degrees of significance in different cases. However, their presence or absence would be cumulative in effect. Since the conclusions to be drawn from consideration of these different relevant circumstances may be in conflict or partially so, determination as to whether a particular combination is a purchase or a pooling of interests should be made in the light of all such attendant circumstances.

8. When a combination is deemed to be a purchase, the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration, or at the fair value of the property acquired, whichever is more clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.

9. When a combination is deemed to be a pooling of interests, a new basis of accountability does not arise. The carrying amounts of the assets of the constituent corporations, if stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform accounting basis, should be carried forward; and the combined earned surpluses and deficits, if any, of the constituent corporations should be carried forward, except to the extent otherwise required by law or appropriate corporate action. Adjustments of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination are ordinarily equally appropriate if effected in connection with a pooling of interests; however, the pooling-of-interests concept implies a combining of surpluses and deficits of the con-

stituent corporations, and it would be inappropriate and misleading in connection with a pooling of interests to eliminate the deficit of one constituent against its capital surplus and to carry forward the earned surplus of another constituent.

10. Where one or more of the constituent corporations continues in existence in a subsidiary relationship, and the requirements of a pooling of interests have been met, the combination of earned surpluses in the consolidated balance sheet is proper since a pooling of interests is not an acquisition as that term is used in paragraph 3 of chapter 1(a) of Accounting Research Bulletin No. 43 which states that earned surplus of a subsidiary corporation created prior to acquisition does not form a part of the consolidated earned surplus. Under the pooling-of-interests concept, the new enterprise is regarded as a continuation of all the constituent corporations and this holds true whether it is represented by a single corporation or by a parent corporation and one or more subsidiaries. If, however, prior to the origin of a plan of combination one party to the combination had been acquired by another such party as a subsidiary in circumstances which precluded the transactions from being considered a pooling of interests, the parent's share of the earned surplus of the subsidiary prior to such acquisition should not be included in the earned surplus of the pooled corporations.

11. Because of the variety of conditions under which a pooling of interests may be carried out, it is not practicable to deal with the accounting presentation except in general terms. A number of problems will arise. For example, if a single corporation survives in a pooling of interests, the stated capital of such corporation may be either more or less than the total of the stated capitals of the constituent corporations. In the former event, the excess may be deducted first from the total of any other contributed capital (capital surplus), and next from the total

of any earned surplus, of the constituent corporations. When the stated capital of the surviving corporation is less than the combined stated capitals of the constituent corporations, the difference should appear in the balance sheet of the surviving corporation as other contributed capital (capital surplus), analogous to that created by a reduction in stated capital where no combination is involved.

12. When a combination is considered to be a pooling of interests, statements of operations issued by the continuing business for the period in which the combination occurs should ordinarily include the combined results of operations of the constituent interests for the part of the period preceding the date on which the combination was effected; if combined statements are not furnished, statements for the constituent corporations prior to the date of combination should be furnished separately or in appropriate groups. Results of operations of the several constituents during periods prior to that in which the combination was effected, when presented for comparative purposes, may be stated on a combined basis, or shown separately where, under the circumstances of the case, that presentation is more useful and informative. Disclosure that a business combination has been, or in the case of a proposed combination will be, treated as a pooling of interests should be made and any combined statements clearly described as such.

The statement entitled "Business Combinations" was unanimously adopted by the twenty-one members of the committee.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

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COMMITTEE ON ACCOUNTING PROCEDURE (1956-1957)

WILLIAM W. WERTZ, Chairman
GORDON S. BATTELLE
GARRETT T. BURNS
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Director of Research

Accounting Research BULLETINS

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April, 1958

No. 49

Earnings per Share

1. Statistical presentations of periodic net income (or loss) in terms of earnings per share¹ are commonly used in prospectuses, proxy material, and annual reports to shareholders, and in the compilation of business earnings statistics for the press, statistical services, and other publications. This bulletin deals with a number of problems arising in the computation and presentation of such statistics.

2. The committee has previously considered certain aspects of this matter² and now reaffirms its earlier conclusions that:

- (a) It is, in many cases, undesirable to give major prominence to a single figure of earnings per share;
- (b) Any computation of earnings per share for a given period should be related to the amount designated in the income statement as net income for such period; and
- (c) Where material extraordinary charges or credits have been excluded from the determination of net income, the per-share amount of such charges and credits should be reported separately and simultaneously.

3. Not only does the use of a single figure for earnings per share involve the same limitations of usefulness as does a single figure

¹As used herein, the term *earnings per share* connotes either earnings or losses per share.

²Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (1953), Chapter 8, par. 14. Also see Chapter 2(b), par. 4.

for net earnings, but also, in many circumstances, the computation of earnings per share involves unique problems. While it is desirable to achieve as much uniformity as is feasible, clear explanation and disclosure of methods used are especially important in this area of financial reporting.

4. The committee suggests the following general guides to be used in computing and presenting earnings per share:

- (a) Where used without qualification, the term *earnings per share* should be used to designate the amount applicable to each share of common stock or other residual security outstanding
- (b) Earnings per share, and particularly comparative statistics covering a period of years, should generally be stated in terms of the common stock position as it existed in the years to which the statistics relate, unless it is clear that the growth or decline of earnings will be more fairly presented, as for example, in the case of a stock split, by dividing prior years' earnings by the current equivalent of the number of shares then outstanding.
- (c) *In all cases in which there have been significant changes in stock during the period to which the computations relate, an appropriate explanation of the method used should accompany the presentation of earnings per share.*

SINGLE-YEAR COMPUTATIONS

5. In the computation of earnings per share for a single year, minor increases or decreases in the number of shares outstanding during the year may be disregarded, and it is appropriate to base the computation on the number of shares outstanding at the end of the year. In the case of a substantial increase or decrease in the number of shares resulting from the issuance or reacquisition of stock for cash or other property during the year, it is generally appropriate to base the computation of earnings per share on a weighted average of the number of shares outstanding during the year. Where there has been little or no opportunity to utilize the proceeds from the issuance of such shares, as would most clearly be the case when the shares were issued shortly before the end of the year, such

shares may be disregarded in the computation. When an increase in the number of shares outstanding results from a stock dividend or a stock split, or a reduction in the number of shares outstanding results from a reverse split, without proceeds or disbursements, the computation should be based on the number of shares outstanding at the end of the year. For purposes of determining the number of shares outstanding, reacquired shares should be excluded.

6. If there has been a stock split⁸ or a reverse split after the balance-sheet date but before the issuance of the financial report, it is desirable to base the computation of earnings per share on the new number of shares, since the reader's primary interest is presumed to be in the present stock position. Similar considerations may apply to stock dividends,⁸ although a relatively small stock dividend may properly be disregarded. In these cases of changes after the balance-sheet date, it is preferable to choose the more useful and informative basis of computation rather than to present two simultaneous and possibly confusing computations on different bases. When computations of earnings per share reflect changes in the number of shares after the balance-sheet date, it is important that this fact be clearly disclosed since there may be a presumption that earnings per share are based on the number of shares shown on the balance sheet. It is equally important that significant changes in the number of shares after the balance-sheet date be disclosed when such changes are not reflected in the computation of earnings per share.

7. Where there are shares outstanding senior to the common stock or other residual security, the claims of such securities on net income should be deducted from net income or added to net loss before computing per-share figures, since the term *earnings per share* is ordinarily used to designate the amount applicable to each share of common stock or other residual security outstanding. In arriving at net income applicable to common stock for purposes of the per-share computations, provision should be made for cumulative preferred dividends for the year, whether or not earned. In the case of a net loss, the amount of the loss should be increased by any cumulative preferred stock dividends for the year. Where such

⁸ See Accounting Research Bulletin No. 43, Chapter 7(b).

dividends are cumulative only if earned, no adjustment of this nature is required except to the extent of income available therefor. In all cases the effect that has been given to dividend rights of senior securities in arriving at the earnings per share of common stock should be disclosed.

8. The following special considerations relate to convertible securities:

- (a) When debt capital, preferred stock, or other security has been converted into common stock during the year, earnings per share should ordinarily be based on a weighted average of the number of shares outstanding during the year. When the weighted average is used in such cases, adjustments for the year in respect of interest or other related factors are not made.
- (b) When capitalizations consist essentially of two classes of common stock, one of which is convertible into the other and is limited in its dividend rights until conversion takes place as, for example, when certain levels of earnings are achieved, two earnings-per-share figures, one assuming conversion, are ordinarily necessary for full disclosure of the situation.

COMPARATIVE STATISTICS

9. Presentations of earnings-per-share data for a period of several years should be governed basically by the criteria for single year presentations, but may involve a number of special considerations in view of changes in conditions during the period, and the purpose for which the data are to be used. It should be recognized that any tabulation of earnings per share for a period of years may have little bearing on the present position, and may fail to give any indication of present expectations. Variations in the capital structure may have substantial effects on earnings per share. The usefulness of such statistics depends in large measure on collateral historical information and disclosure of methods of computation used. The committee's recommendations which follow are intended as guides to general uniformity but not as substitutes for explanations and

disclosures or as cures for the inherent defects in statistical presentations of earnings per share.

10. When computations of earnings per share for a period of years, such as are submitted in annual reports and in prospectuses, include periods in which there have been stock splits or reverse splits, the earnings for periods prior to the dates of the splits should be divided by the current equivalent of the number of shares outstanding in the respective prior periods in order to arrive at earnings per share in terms of the present stock position. Similar treatment should be accorded to stock dividends; however, it is permissible not to extend such treatment to small recurrent stock dividends, although in a prospectus or when such dividends in the aggregate become material, consideration should be given to recognizing the cumulative effect thereof. On the other hand, where, during the period of years for which data are given, there have been issuances or reacquisitions of stock for cash or other property, or, issuances in connection with conversions of debt capital, preferred stock, or other security, the computations of earnings per share for the years prior to such changes are not affected; it follows that earnings per share for these years should be based on the number of shares outstanding in the various years. When both situations have occurred, the effect of each should be reflected in accordance with the foregoing recommendations.

11. When equity securities are being publicly offered:

- (a) If there have been significant conversions of debt capital, preferred stock, or other security during the period of years for which data are given, it is appropriate to present supplementary calculations revising past figures to reflect subsequent conversions, on a pro forma basis.
- (b) If the securities being offered, or their proceeds, are to be used to retire outstanding securities in circumstances which assure such retirement, it may be useful to present, in addition to otherwise appropriate calculations, supplementary computations to show pro forma earnings per share for at least the most recent year as if such substitution of securities had been made. When this is done, the basis of the supplementary computations should be clearly disclosed. Where, however, the securities being offered, or their proceeds, are

to be used, not to retire existing securities, but for such purposes as expansion of the business, earnings per share should be computed without adjustment for any increase in the number of shares anticipated as a result of such offering.

12. Where there has been a pooling of interests⁴ during the period of years for which data are given, in connection with which the number of shares outstanding or the capital structure in other respects has been changed, the method used in computing earnings per share for those years prior to the pooling of interests should be based on the new capital structure. When there is to be a pooling of interests in connection with which the number of shares outstanding or the capital structure in other respects will be changed, earnings per share for any period for which income statements of the constituent companies are presented in combined form should be computed on a basis consistent with the exchange ratio to be used in the pooling of interests. In either case earnings per share should, in all other respects, be computed in conformity with the principles set forth in the foregoing paragraphs.

EARNINGS COVERAGE OF SENIOR SECURITIES

13. Where periodic net income is related to outstanding shares of senior securities, such as preferred stock, the committee believes that, under most circumstances, the term *earnings per share* is not properly applicable in view of the limited dividend rights of such senior securities. In such cases it may be helpful to show the number of times or the extent to which the requirements of senior dividends have been earned, but such information should not be designated as earnings per share.

MISCELLANEOUS

14. It is impracticable to deal, in this bulletin, with all of the possible conditions and circumstances under which it may be necessary or desirable to compute data in terms of earnings per share—

⁴ See Accounting Research Bulletin No. 48, *Business Combinations* (1957).

for example, acquisitions, mergers, reorganizations, convertible and participating securities, outstanding stock options, retirements, and various combinations of these circumstances. While such situations should be dealt with in harmony with the recommendations made in this bulletin, they call for especially careful consideration of facts and the exercise of judgment in the light of all the circumstances of the case and the purposes for which the data are prepared. In such complex situations as those mentioned in this paragraph, a clear disclosure of the basis on which the computations have been made is essential.

DIVIDENDS PER SHARE

15. Although this bulletin deals primarily with earnings per share, certain considerations may apply comparably to dividends per share. In general, dividends per share constitute historical facts and should be so reported. However, in certain cases, such as a stock split as mentioned in paragraph 10, a presentation of dividends per share in terms of the current equivalent of the number of shares outstanding at the time of the dividend is necessary so that dividends per share and earnings per share will be stated on the same basis. When dividends per share are stated on any other than the historical basis, it is generally desirable that such statement be supplemental to the historical record, and its basis and significance should be fully explained.

The statement entitled "Earnings per Share" was unanimously adopted by the twenty-one members of the committee.

NOTES

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WILLIAM W. WERNITZ, Chairman
 NORTON M. BEDFORD
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 CARMAN G. BLOUGH
 Director of Research

Accounting Research BULLETINS

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No. 50

Contingencies

1. In the preparation of financial statements presenting financial position or operating results, or both, it is necessary to give consideration to contingencies. In accounting a contingency is an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain or loss. A commitment which is not dependent upon some significant intervening factor or decision should not be described as a contingency.

DISCUSSION

2. The contingencies with which this bulletin is primarily concerned are those in which the outcome is not sufficiently predictable to permit recording in the accounts, but in which there is a reasonable possibility of an outcome which might materially affect financial position or results of operations. Examples of contingencies which may result in the incurrence of liabilities, or in losses, are pending or threatened litigation, assessments or possible assessments of additional taxes, or other claims such as renegotiation refunds, that are being or would be contested, guarantees of indebtedness of others, and agreements to repurchase receivables which have been sold. Examples of contingencies which may result in the acquisition of assets, or in gains, are claims against others for patent infringement, price redetermination upward and claims for reimbursement under condemnation proceedings. Material contingencies of the types discussed in this paragraph should be disclosed.

3. Other contingencies may exist where the outcome is reasonably foreseeable, such as probable tax assessments which will not be contested, or anticipated losses from uncollectible receivables. Contingencies of this type which are expected to result in losses should be reflected in the accounts. However, contingencies which might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization;¹ but there should be adequate disclosure.

4. There are also general risk contingencies that are inherent in business operations and which affect many if not all companies, such as the possibility of war, strike, losses from catastrophies not ordinarily insured against, or a business recession. Contingencies of this type need not be reflected in financial statements either by incorporation in the accounts or by other disclosure.²

DISCLOSURE

5. Disclosure of contingencies referred to in paragraph 2 should be made in financial statements or in notes thereto. The disclosure should be based as to its extent on judgment in the light of the specific circumstances and should indicate the nature of the contingency, and should give an appraisal of the outlook. If a monetary estimate of the amount involved is not feasible, disclosure should be made in general terms describing the contingency and explaining that no estimated amount is determinable. When amounts are not otherwise determinable, it may be appropriate to indicate the opinion of management or counsel as to the amount which may be involved. In some cases, such as a law suit involving a substantial amount, management may reasonably expect to settle the matter without incurrence of any significant liability; however, consideration should be given to disclosing the existence of the litigation and the opinion of management or counsel with respect thereto. Although disclosures discussed here should be made with respect to those contingencies which may result in material gains or assets as well as with respect to those which may result in material losses or liabilities, care should be exercised in the case of gains or

¹ See Chapter 1, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*.

² For the committee's position with respect to contingency reserves, see Chapter 6 of Accounting Research Bulletin No. 43.

assets to avoid misleading implications as to the likelihood of realization. The discussion in this bulletin does not deal with the question as to whether the existence of any of the contingencies discussed above is such as to require a qualified opinion or a disclaimer of an opinion by the independent certified public accountant.

6. Certain other situations requiring disclosures have sometimes inappropriately been described as though they were contingencies, even though they are of a nature not possessing the degree of uncertainty usually associated with the concept of a contingency. Examples are unused letters of credit, long-term leases, assets pledged as security for loans, pension plans, the existence of cumulative preferred stock dividends in arrears, and commitments such as those for plant acquisition or an obligation to reduce debts, maintain working capital, or restrict dividends. While some of these situations may develop into contingencies, they should **not** be described as contingencies prior to such eventuality.

The statement entitled "Contingencies" was adopted unanimously by the twenty-one members of the committee, of whom two, Messrs. Bedford and Halvorson, assented with qualification.

Mr. Bedford objects to the provision in paragraph 3 that anticipated losses due to a contingency should be recognized in an accounting period prior to the actual incurrence of the loss. He believes that such deductions from revenue, in order to match adequately costs and revenues, should be based upon sufficient statistical evidence or experience to justify an accounting treatment different from that afforded gains. Without the sufficient statistical evidence or experience and without evidence to indicate a loss has been incurred, he believes a contingent loss should be disclosed in such a manner as not to require the recognition of the loss until the loss has been incurred.

Mr. Halvorson believes the bulletin fails in the essential matter of definition in the second sentence of paragraph 1. He feels that "a considerable degree of uncertainty" is beside the point, and that the definition as it stands would not exclude many types of commitments. He believes that the point should be that the "existing condition" and the "related future event" would affect present financial position or pres-

ent or past operations, and would be so recorded in the statements, if all the uncertainties could be resolved at the time the statements are being issued. He also believes that the bulletin should not deal with the "general risk" contingencies described in paragraph 4, as they are not of a peculiarly accounting nature, and the attempt to accommodate them in an accounting bulletin has required a definition that is so broad as to fail in its purpose.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

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2. *Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.*

3. *It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.*

COMMITTEE ON ACCOUNTING PROCEDURE (1957-58)

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Director of Research

Accounting Research BULLETINS

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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 inter-

company 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.

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

¹ See Accounting Research Bulletin No. 48, *Business Combinations*, for the difference in treatment between a purchase and a pooling of interests.

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 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.

¹ See Accounting Research Bulletin No. 48, *Business Combinations*, for the difference in treatment between a purchase and a pooling of interests.

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 or 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 un-

consolidated 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, Halvorson, Hoyler, Kent, Powell, and Wertz, 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.

Messrs. Halvorson and Wertz 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 a 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 of 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.

NOTES

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WILLIAM W. WERTZ, Chairman
NORTON M. BEDFORD
GARRETT T. BURNS
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CARL M. ESENOFF
CLIFFORD E. GRAESE
WILLARD J. GRAHAM
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Director of Research