

7-1926

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Walter M. LeClear

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Recommended Citation

LeClear, Walter M. (1926) "Consolidated Balance-sheets and Contingent Liabilities," *Journal of Accountancy*. Vol. 42 : Iss. 1 , Article 2.

Available at: <https://egrove.olemiss.edu/jofa/vol42/iss1/2>

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Consolidated Balance-sheets and Contingent Liabilities*

BY WALTER M. LECLEAR

There has been a great deal of discussion among accountants with regard to the question, "When should the accountant insist on preparing consolidated balance-sheets?"

It is not my intention to dwell on the income-tax features of consolidated returns, but I shall briefly discuss that phase of the case because the conclusions reached by the treasury department and the decisions by the board of tax appeals are entitled to be given considerable weight by the accountant in the preparation of consolidated statements for other than income-tax purposes.

The 1917 act contained nothing about consolidations, but the treasury department under that act promulgated regulations which, before consolidated returns would be permitted or demanded, required the substantial ownership or control of one organization by another, or the substantial ownership or control of two or more organizations by the same interests, and further required that the two or more organizations be engaged in the same or similar businesses. The 1918 and 1921 acts contained provisions similar to the regulations under the 1917 act but eliminated the question of the same or similar businesses and limited consolidations to corporations. The 1924 and 1926 acts ignore control and require an ownership of 95 per cent. or more of the outstanding voting stock. For consolidations subsequent to 1925 there must be an ownership of 95 per cent. of all the stock except "non-voting stock which is limited and preferred as to dividends".

Had the earlier acts used a fixed percentage in place of the word "substantial", a great many controversies with the government would have been avoided because the word "substantial" is far from being definite. On the other hand, however, I believe that the arbitrary requirement of 95 per cent. in the 1924 and 1926 acts is too high a rate for universal application.

The commissioner of internal revenue at one time took the position that all consolidated returns under the 1917, 1918 and 1921 acts wherein an ownership of less than 95 per cent. existed should be rejected; in other words, he interpreted the word "substantial" as used in the revenue act to mean 95 per cent. The board of tax

*Address delivered at a joint meeting of the Illinois Society of Certified Public Accountants and the Chicago chapter of the Robert Morris Associates, Chicago, April 15, 1926.

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appeals has, however, repeatedly held that the commissioner's interpretation was erroneous and that each case must be considered on its merits, and in several cases has approved consolidated returns where the ownership was slightly over 50 per cent. On the other hand, under a different set of facts the board has rejected consolidations where the ownership was as high as 80 per cent.

I am firmly of the opinion that the board is correct and has taken a much more practical view of the subject than has the commissioner or is intended by the 1924 and 1926 acts.

I believe that it is impossible to prescribe a definite rule and that there should be a fixed percentage representing a deadline beyond or below which a consolidated balance-sheet shall or shall not be prepared. All the factors should be taken into consideration before the question is determined, and they may be classified as follows:

1. Percentage of direct ownership of voting stock.
2. Degree of control of voting stock not directly owned—that is, ownership by the same interests.
3. Degree of control through management (including interlocking directorates).
4. Operation of companies as a single business unit or enterprise.
5. Inter-company sales at other than regular prices.
6. Ownership of preferred stock or bonds, and other methods of inter-company financing.
7. Other inter-company transactions.

In so far as it is possible to indicate fixed percentages, the following may serve as a useful guide:

1. Where there is a direct ownership of 95 per cent. or more, a consolidated balance-sheet should be prepared.
2. Where there is a direct ownership of less than 95 per cent. but more than 75 per cent. the presumption should be affirmative and unless there are very definite reasons to the contrary a consolidated balance-sheet should be prepared.
3. Where the direct ownership is less than 75 per cent. but more than 50 per cent. the presumption is negative. Where the direct ownership is over 50 per cent. and a consolidated balance-sheet is not prepared the value of the investment should be adjusted so that it will represent the cost plus earnings less the dividends of the issuing company.

4. In cases where there is stock ownership and a consolidated balance-sheet is not prepared, the bills and accounts receivable should be segregated to show the amount due from the company or companies in which there is stock ownership and a similar segregation should be made of the item of investments. Such segregations should apply in many cases where there is much less than a 50 per cent. ownership.

Some years ago as representative an organization as the Anacoda Copper Company adopted the policy of preparing consolidated statements which included all subsidiaries in which it held an ownership of 75 per cent. or more. In other instances agreements concerning note or other security issues by subsidiary companies frequently require consolidated statements where there is an ownership of 75 per cent. or more.

FEDERAL INCOME TAXES FOR PRIOR YEARS

Another matter of current discussion among accountants is the question, "How should federal income taxes for prior years which are unsettled be shown on the balance-sheet and how should the accountant ascertain what the situation may be?"

This question is of much greater importance in considering the years of the high taxes applicable prior to 1922 than subsequent years, because in most cases it is not a very difficult matter for the accountant to satisfy himself as to the liability for the latter years, whereas the liability for years prior to 1922 is not always so easily determined.

There are a large number of cases, with years prior to 1922 involved, still pending in the bureau of internal revenue and in a great many of these cases it is quite impossible even to venture a guess as to how the case may finally terminate. Take a case, for example, wherein the department has made an examination and has indicated that additional taxes of \$100,000 will be assessed for the years 1918-1919 and 1920, and the taxpayer, having been unable to convince the department which has made the examination that such additional taxes are erroneous, has requested that the case be referred to the special assessment section for determination of the tax under the relief sections 327 and 328 (and that is where a great many of the old cases are now pending). This section first determines whether or not there are any abnormalities with regard to either invested capital or income which justify the taxpayer in asking for relief. If it so determines, the next step is

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to compare the rate of excess- or war-profits tax with the rates paid by representative concerns similarly situated. It is therefore very easy to see that the accountant, or for that matter any one other than a fortune teller, has quite a job even to venture a guess at the final conclusion.

It seems to me that the accountant might proceed along the following lines: Obtain the tax file of the organization and ascertain what years have been examined and what years have been settled. Any years which have been examined but are unsettled should be covered by a department letter and if this letter indicates additional taxes which the taxpayer denies and the probable outcome of which is not plainly apparent, a statement should be made on the balance-sheet to the following effect: "An investigation by the bureau of internal revenue for the years 1918 to 1921, inclusive, indicates that additional income and profits taxes amounting to \$100,000 will be levied; the company, however, has requested that the case be referred to the special assessment section for determination. It is impossible to forecast the final conclusion." Again, the case may be pending before the board of tax appeals. In any event, where additional taxes are indicated but the final result is uncertain the situation should be explained by means of a footnote on the balance-sheet.

PURCHASE COMMITMENTS

There has been considerable discussion about purchase commitments and when they should be mentioned on the balance-sheets of manufacturing and merchandising concerns. It appears that in ordinary circumstances and when a concern has approximately the usual amount of purchase contracts outstanding it is not necessary to make any comment, as all businesses are presumed to have arranged for raw materials to the extent necessary to carry on the business.

However, where a concern has placed firm contracts for more than its ordinary requirements or where the material purchased is subject to severe market fluctuations and the market has declined, some mention of the facts should be made by way of a memorandum at the foot of the balance-sheet and in some cases a reserve should actually be set up on the books.

The question of purchase commitments is very closely allied to the question of material in transit. Should such material be included in the inventory and accounts payable, or is no mention

necessary? Here again it would appear that in ordinary circumstances no mention is necessary unless unusually large orders which have been purchased f.o.b. shipping point have been shipped, otherwise shipments should fall in and be governed by the comments which have been made with regard to purchase commitments.

It goes without saying that where it can be done, the balance-sheet and other statements should be self-explanatory but unfortunately this is not always possible. The accountant tries to submit his statements in a self-explanatory and practical manner and, when this is not possible, explanations are included in the certificate or the report which accompanies the statements. The credit man or the banker must read all such comments in order to be fully informed.