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Correspondence: Intercompany Profits in Consolidated Statements

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Intercompany Profits in Consolidated Statements

Editor, The Journal of Accountancy:

SIR: Not wishing to engage in a controversy through your columns, but feeling that the subject of consolidated statements is one of growing importance to the accounting profession, I am making bold to give you my comments upon the letter from W. T. Sunley published on page 310 of the October, 1923, issue of THE JOURNAL OF ACCOUNTANCY, which discusses an article contributed by me entitled *Elimination of Intercompany Profits in Consolidated Statements,* published in the July JOURNAL.

The question at issue regards profits or losses upon sales made by one affiliated company to another, in cases where there are minority stock interests concerned. Under the generally accepted principle, no account is taken of such transactions until the subject-matter of the sale has been acquired by an outside purchaser. Mr. Sunley, in an article published in the May JOURNAL, contended, and to my mind proved, that in instances where goods were sold at a profit by a subsidiary having minority stockholders to a parent company, the proportion of the profit made by the subsidiary which must be allowed for in the consolidated surplus as applicable to the minority should be considered as a part of the cost of the consolidated inventory and should not be eliminated. In my article, I endeavored, as Mr. Sunley correctly states, to go a little further in applying the same principle whether the parent company be buyer or seller—in other words, viewing the latter instance as an "outside" sale with a profit or loss realized to the extent that minority holders are interested in the transactions.

Mr. Sunley seems to object to proceeding to this extent for two reasons: first, that it would open an avenue for manipulation, and, secondly, that it leans too much toward the legal viewpoint of considering the affiliated companies as separate and distinct corporations, rather than treating them from the accountant's point of view as one business consisting of related branches.

In regard to the former criticism, the avenue for manipulation appears to be opened as widely under the present rule or Mr. Sunley's suggestion as under mine. To reverse the illustration used by him, let us imagine that property worth $100,000 is sold not at a profit but at a loss by the parent to the subsidiary, say for $5,000. Under the present practice of eliminating this transaction altogether, because the contracting parties are affiliated, and under Mr. Sunley's plan of eliminating it, because the parent is the seller, the consolidated statement would not reflect any change at all by reason of it. Corporate officers may happen to be more interested in the profits of a subsidiary than of the parent and thus be pleased to have the matter exhibited in this manner. The same sort of manipulation might be practised by causing the parent to purchase goods from a subsidiary at a loss to the latter, in this way decreasing the proportion of consolidated surplus applicable to the minority interests.

If we wish to be consistently conservative, we should prohibit the taking up of losses on sales by a subsidiary to a parent or the taking up of profits on sales by a parent to a subsidiary, and should insist upon showing profits on sales by a subsidiary to a parent and losses on sales by a parent to a subsidiary. This, to my mind, is a logical requirement if we adopt as our guiding principle that the consolidated statement is to reflect only those intercompany transactions which are favorable to the minority holders and not those favorable to the parent or majority holders. However, there seems to be no good reason for attempting to curb manipulation through any rule of this kind—in the first place, because it would not be an effective deterrent, and then it necessitates an understatement of the book value of the majority holdings.

In regard to the second point made by Mr. Sunley—that the adoption of the principle suggested would, in cases where the parent company was the seller, result in losing sight of the accounting unity of the enterprise—I must confess that I fail to see why this is so any more than when the parent is buyer. The consistent recognition of minority interests in intercompany transactions is the most accurate viewpoint obtainable. It disregards the fact of separate corporate entities as far as the stock interests of the parent company are concerned, endeavoring to treat the equity of the parent in each subsidiary as part and parcel of the consolidated undertaking. It seeks to eliminate the equity of the minority in each and every bona-fide transaction.

Perhaps Mr. Sunley himself adopts a somewhat strict legal point of view in contending that an actual liquidation or judicial approval is necessary before a sale can be considered closed. However, he does not insist upon this position when the parent is buyer but only when it is seller.

I am fully in accord with the principle enunciated in the last paragraph of Mr. Sunley's letter—"that in actual practice, the accountant will, of course, guide his actions by the attendant circumstances." If a sale has been made by one affiliated company to another and the accountant has satisfied himself of the propriety of the transaction, which is his first duty, then his second duty is to state the results of that transaction in the most accurate manner possible. In my humble opinion, the accounting profession cannot go far wrong in approving mathematically exact statements if the "attendant circumstances" indicate no unfair manipulation, realizing that artificial rules intended to prevent dishonest practices can just as frequently be employed as a cloak for such acts.

Yours truly,
Gordon C. Carson.

Savannah, Georgia, Oct. 8, 1923.

The firm of A. W. Wright & Co., consisting of A. W. Wright and Kurt W. Freund, announce the opening of an office at 303 Fifth avenue, New York, and also an office in Baltimore, Maryland.