Journal of Accountancy

Volume 62 | Issue 5 Article 4

11-1936

Consolidated Financial Statements

Victor H. Stempf

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation
Stempf, Victor H. (1936) "Consolidated Financial Statements," *Journal of Accountancy*: Vol. 62: Iss. 5, Article 4.
Available at: https://egrove.olemiss.edu/jofa/vol62/iss5/4

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Consolidated Financial Statements *

By Victor H. Stempf

Consolidated financial statements involve many problems which have been presented in the meetings of the American Institute of Accountants on occasions in the past. It is not the purpose of this discussion to stress these problems, but rather to allude to some of them while tracing the evolution of varying practices in use today. Many of these practices are recognized by the securities and exchange commission in its emphasis upon adequate disclosure. Under the securities legislation, both management and the public accountant are responsible for the disclosure of all material facts which reasonably may be expected to influence the conclusions of a prudent investor. The profession has always stressed disclosure of material fact within the limits of its ability. It is from this point of view that the preparation of consolidated statements should be considered.

Until comparatively recent times many holding company reports were quite uninformative, presenting as they did one large total of "investments in, and advances to, subsidiary companies," without comment as to the degree of control, solvency or results of operations of the subsidiaries. This form of presentation was manifestly unsatisfactory.

How may one best obtain a comprehensive financial summary of an enterprise as a whole? Separate financial statements of each subsidiary presented with those of the parent comprise the jig-saw pieces of the picture puzzle. Such separate statements provide the data in accordance with legal concepts, minimize the possibilities of inadequate disclosure and avoid the dangers of misconstruction, but they leave the major work of summarization and diagnosis to the more or less helpless investor. Is it not better for management to make the representations concerning the correlation of these data, than to have those less informed attempt the consolidation, with the risk of misinterpretation and erroneous combination of accounts? The answer is found in consolidated statements, but not without attendant difficulties.

*An address delivered before the American Institute of Accountants at Dallas, Texas, October 20, 1936.

For whom are consolidated statements prepared? Do such statements alone assist a lender in his credit appraisal? Obviously, consolidated statements are useless to the short-term creditor of a subsidiary company. He relies upon the liquidity of the debtor company, unless he has had the foresight to obtain an endorsement or other guaranty. If the parent be an operating as well as a holding company its short-term creditors would insist, logically, upon the unconsolidated statements of the borrower as the primary basis for the extension of credit.

The long-term creditor of a subsidiary company usually is not concerned about consolidated statements. He, too, wants the debtor company's statement, although he may be interested in the relationship of the debtor company to an affiliated group as to the influence of that relationship upon the prospects of the debtor company.

Long-term creditors of holding companies, as well as stockholders of such companies, unquestionably are more interested in consolidated statements (which reflect the aggregate resources behind their investments and the consolidated earnings to which they may look for their income) than they are in unconsolidated statements which withhold the details of underlying balance-sheets and state surplus on the basis of subsidiary earnings legally transferred by dividend to the parent.

History of Consolidated Statements Here and Abroad

Use in the United States:

The use of consolidated statements became prevalent much earlier in the United States than elsewhere. Perhaps it may be said that accountants in the United States were pioneers in advocating such statements. Notwithstanding the absence of legal recognition, in the United States, apart from tax considerations, consolidated balance-sheets were published at the turn of the century. The initial forms were of the columnar type. Such reports to stockholders generally have omitted the statements of the parent company alone. It is interesting to observe, however, that since its inception, the federal reserve bank has required the filing of parent company statements with rediscounted paper.

Use in Great Britain:

Granting that consolidated statements have been known in Great Britain for many years, it appears that the profession there

took only a lukewarm interest in them until after Sir Gilbert Garnsey's book, *Holding Companies and Their Published Accounts*, brought the subject prominently to the attention of accountants in 1923. Since then the use of consolidated statements has increased slowly but still is not as general as in the United States.

Under the British companies act of 1929, the separate balance-sheet of the reporting company must be published, but it is common practice for a holding company to publish its own separate balance-sheet and, in addition, either consolidated statements of the holding company and subsidiaries or consolidated statements of the subsidiaries only. This practice is commendable and, no doubt, has influenced the existing requirements of the securities and exchange commission in the United States.

Although the British companies act does not demand the preparation of consolidated statements, the law does require segregation of investments and inter-company accounts of subsidiaries in the balance-sheet of the parent. It requires that there be annexed to the balance-sheet of a company having subsidiaries a signed statement setting forth how the profits and losses of such subsidiaries have been dealt with in the accounts of the parent and to what extent (a) provision has been made for losses of subsidiaries in the accounts of such companies or the parent, or both, and (b) to what extent losses of subsidiaries have been taken into account in determining the profit or loss of the parent as disclosed in its accounts. The law requires, also, that any qualifications in the auditors' reports concerning such subsidiaries shall be repeated in the report accompanying the accounts of the parent.

Use in Canada:

In Canada, consolidated statements have been popular for many years; and for ten years the dominion income-tax department has accepted returns based on consolidated figures.

Apart from tax consideration, the consolidated balance-sheet was not recognized legally in Canada until 1934, although it was the practice in many cases for holding companies to present consolidated statements, in addition to their legal balance-sheets, at their annual meetings.

The Canadian companies act of 1934 calls for consolidated statements, for purposes of a prospectus, but for purposes of an annual report consolidated statements are optional. However,

specific provision is made for the disclosure of the treatment of profits and losses of non-consolidated subsidiaries and for the segregation, in the balance-sheet of the parent, of investments in and advances to and from subsidiaries.

Pronouncements of the American Institute of Accountants:

Official recognition of consolidated statements by the American Institute of Accountants has evolved slowly.

While it is true that the three Institute bulletins concerning the examination of financial statements have dealt primarily with audit procedure, each of the bulletins has discussed also the presentation of statements.

The first of these bulletins, issued in 1917, made no reference to consolidated statements. The only comment on subsidiary companies was:

"Where stocks or bonds represent control or a material interest in other enterprises, the ownership of which carries more or less value to the holder outside of return thereon, they should be considered as fixed assets."

The bulletin of 1929 made no reference to consolidated statements and restated the language regarding securities of subsidiaries, substituting the title "permanent investments," and providing that such amounts should be stated apart from current assets. That bulletin also stated:

"Any inter-company relationships giving rise to profits or losses should be borne in mind when determining cost of sales."

No further elaboration of the subject was given.

The bulletin of 1936 has a section dealing specifically with consolidated statements, and under the headings of "surplus" and "sales and cost-of-sales" refers to earnings and profits of subsidiaries, the elimination of inter-company profits, etc.

Other pronouncements:

At the convention of the American Institute of Accountants in 1930, J. M. B. Hoxsey, of the New York stock exchange, presented an admirable address in which he discussed consolidated statements, referring to them as the "most pronounced step forward in the direction of adapting accounting to the needs of investors." He said also:

"Consolidated statements would appear to be of use to management only as to the broadest aspects of business. . . . Why not let them obtain their maximum usefulness by preparing consolidated accounts including all corporations in which, directly or indirectly, there is a holding of a majority of the voting stock? . . . No accountant should certify partly consolidated statements without including in them a clear statement of the company's equity in the current undistributed earnings or losses of its unconsolidated subsidiaries and a statement of its equity in their earned surplus since acquisition. . . . After all, it is the parent company whose securities are in the hands of the public and regarding which, . . . information is necessary; and while parent company statements alone fall short of satisfactory disclosure, they should always accompany the consolidated statements, so that a complete picture may be presented."

Mr. Hoxsey's address aroused great interest and had an important bearing upon the more general recognition of principles which had been advocated by leaders in the profession.

The listing agreements required by the New York stock exchange under its form 22 issued in September, 1936, make the following provisions concerning published financial statements:

"1. The corporation will publish at least once in each year . . . a balance-sheet . . . and a surplus-and-income statement of the corporation as a separate corporate entity and of each corporation in which it holds directly or indirectly a majority of the equity stock; or, in lieu thereof, eliminating all inter-company transactions, a consolidated balance-sheet, . . . a consolidated surplus statement and a consolidated income statement of the corporation and its subsidiaries for such fiscal year. If any such consolidated statement shall exclude corporations a majority of whose equity stock is owned directly or indirectly by the corporation: (a) the caption of, or a note to, such statement will show the degree of consolidation; (b) the consolidated income account will reflect, either in a footnote or otherwise, the parent company's proportion of the sum of, or difference between, current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of the report; and (c) the consolidated balance-sheet will reflect, either in a footnote or otherwise, the extent to which the equity of the parent company in such subsidiaries has been increased or diminished since the date of acquisition as a result of profits, losses and distributions."

It should be noted that both (b) and (c) above relate to unconsolidated subsidiaries and, inferentially, recognize the practice of recording appreciation or depreciation of investments in

subsidiaries by a direct credit or debit to the parents' earned surplus, concerning which more will be said later in this discussion.

It is believed to be the tendency of the exchange to require both single and consolidated statements, but the single statements are not demanded when consolidated statements are submitted, unless the single statements add vital information.

Under the auspices of the department of commerce, T. H. Sanders, of Harvard, prepared a report in 1934 entitled: *Reports to Stockholders*, in which he said:

"Accountants and business men hold widely differing views upon many aspects of consolidated reports, and for purposes of obtaining improvement in corporate reporting practices it is *not* desirable to hurry a settlement of these differences. On the contrary the greatest progress in this field will result from a continuation of the debate. No rule of thumb criteria can be established at this time, but the consolidated report should state any general principle which is followed by the company. The report should refer to accompanying schedules of those companies which are consolidated and those which are not, indicating preferably the percentage of ownership in each case. It should also indicate the practice observed by the company in preparing its consolidated report with respect to stating assets and liabilities, minority interests, capital stock, surplus, inter-company eliminations, gross earnings, cost of sales and dividends. Here again the important consideration is that the investor be able to determine what has been done in the given case rather than that all companies follow a uniform procedure. Consolidated reports should state the equity of the parent company in the undistributed gains or losses of unconsolidated subsidiaries for the period under report, and also its equity in their surplus or deficit accumulated since they were acquired. Likewise such statements should reflect the existence of any default in the interest, cumulative dividend or sinking-fund requirements of any controlled corporation whether consolidated or not."

These pithy recommendations are embodied very largely in the rules and regulations adopted by the securities and exchange commission, and public accountants, generally, concur in the principles prescribed.

Section 20 of the securities act of 1933, as amended, and section 13(b) of the securities exchange act of 1934, relating to the special powers of the commission, both authorize the commission to demand consolidated financial statements when deemed necessary or desirable.

The instructions promulgated pursuant to both acts are basically the same. Differences relate primarily to conditions under which certain statements may or may not be required. In no event may the unconsolidated balance-sheet of the registrant be excluded, although under certain conditions the unconsolidated profit-and-loss account may be omitted.

The instructions of the securities and exchange commission also provide that when certain subsidiaries are excluded from consolidated statements, although the registrant owns securities representing more than 50% voting power other than as affected by conditions of default, separate sets of statements in which all such subsidiaries are consolidated in one or several groups are required, as well as separate statements for each subsidiary not included in one of the aforesaid groups.

Furthermore, the instructions relating to the disclosure of advances to subsidiaries in the registrant's balance-sheet provide that indebtedness of any affiliates may be included in current assets if it be in fact current. This means not only that the current position of the debtor company would enable the payment of the account but also that such payment would be forthcoming currently as a matter of established practice.

The Principles of Consolidation

The art of displaying the incidence and effect of financial transactions involves a perpetual endeavor to harmonize legal concepts with recognized business practices and related accounting conventions. The transition in progressive business methods, naturally, is more rapid than in the law. The law evolves slowly as a result of practices which have borne the test of time. A striking example of this disparity is evident in the divergence between the legal and the sound accounting concept of sources available for corporate dividends.

So, too, it recognized that consolidated financial statements have little standing in court, because they ignore the contractual relationships of constituent companies as separate legal entities. Nevertheless such statements find favor in financial circles, affording, as they do, a comprehensive recapitulation of the finances of associated companies as if they were departments of one company. Consolidated statements are essential to management and investors, to provide a bird's-eye view of the aggregate activities of a going enterprise.

One may say that most of the difficulties involved in consolidated statements relate to a misconception of the purposes which such statements seek to accomplish. How may the purposes of consolidated statements best be served? On the theory that consolidated statements should present a composite picture of the aggregate activities of an enterprise, such statements should combine the component parts from the standpoint of a single business. The principles governing the preparation of consolidated statements should be the same as those which govern the transactions of a single corporation.

General basis of assets in consolidation:

In a single corporation, specific assets may have been acquired partly for cash, partly for stock or as part of a mixed aggregate of assets for an up-set consideration of cash or stock or both. The stock issued by the purchaser may have been considered in its accounts at par value, book value or market price, and the allocation of amounts to acquired assets may have been arbitrary or based upon appraisal. So, too, in each subsidiary, like conditions may have prevailed, aggravated, upon consolidation, by the question of the true basis of such assets in the consolidation.

It seems that the circumstances of the acquisition of subsidiaries by the parent should control the basis of stating the amounts of assets of each subsidiary included in the consolidation, as opposed to the theory that the consolidation should reflect a summarization of the cost of assets to the respective constituent companies. The later hypothesis does not appear to be consistent with the single-company theory, because it injects the legal concept of separate corporate entities. It would follow that cost to the subsidiary is cost to the consolidated group only if the expenditure occurred subsequent to the acquisition of the subsidiary by the parent.

A simple demonstration of the single-company viewpoint may be cited in the example of a company which buys land for $100,000 in cash and a building thereon for $500,000 in cash. Some years later the stock of the company is sold to another corporation for $1,000,000 in cash, and the company which becomes a subsidiary has no assets of substantial value except the land and building. From a consolidated standpoint it would seem incongruous to state the amount of such assets at the cost to the subsidiary. In buying the stock of the subsidiary, the parent acquired land and building which the parent believed to be worth $1,000,000.

In fixing the consideration of $1,000,000, the buyer determined by disinterested appraisal that the value of the land was $250,000 and that of the building $750,000. Does it not follow, on a consolidated basis, that the income statement of the group should include depreciation on the $750,000 value of the building and not on the subsidiary's cost of $500,000? The subject is one on which divergent views are held, and many consolidated reports are published which use subsidiary cost as the base. However, there is a growing recognition of the desirability of stating the basis of consolidating such amounts and the basis of the related depreciation.

Inclusions in consolidation:

When should subsidiaries be included in the consolidation? No one questions the propriety of including domestic subsidiaries, in related lines of business, which are wholly-owned, and of excluding those which are less than 50% controlled, unless there are exceptional circumstances. Within these limits, the matter is one of judgment, necessitating the disclosure of the general principles of consolidation and careful attention to the presentation of material facts. Attention is directed to the practice of submitting explanatory comments supporting financial statements for the purpose of "spelling-out" substance without materially disturbing the traditional form of statements.

Exclusions from consolidation:

Typical of cases in which judgment may dictate the exclusion of certain subsidiaries from consolidation are those of subsidiaries whose business is distinctly different from that of the regular business of the group. There are stores which have banking subsidiaries, financial institutions which have general insurance subsidiaries and industrials which have utility subsidiaries. In such cases the subsidiaries not only may serve the parent but may obtain the major portion of very substantial earnings from the general public. Furthermore, restriction of the purposes to which assets may be applied and other similar factors may warrant exclusion of such subsidiaries from consolidation.

The general instructions of the securities and exchange commission relative to consolidation provide that:

"The registrant shall not consolidate . . . those companies in which it does not own, directly or indirectly, securities repre-

senting more than 50% of the voting power, other than as affected by events of default. Subject to this provision, the registrant shall follow, . . . that principle of inclusion or exclusion which, in the opinion of its officers, will most clearly exhibit the financial condition and results of the operations of the registrant and its subsidiaries. The principle adopted shall be stated in a note attached to the consolidated balance-sheet."

The instructions also provide:

"1. The difference between the registrant's investment in consolidated subsidiaries and the related equity in net assets as shown by the subsidiaries' books must be stated.

"2. The minority interest in the capital and in the surplus of consolidated subsidiaries must each be shown separately in the consolidated balance-sheet."

Foreign subsidiaries present many problems in consolidation. Unsettled conditions abroad have brought about an increasing exclusion of foreign subsidiaries from consolidated statements, with the noteworthy exception of British and Canadian subsidiaries.

The status of excluded foreign subsidiaries usually may be presented adequately by the inclusion of the aggregate equity in such subsidiaries in the consolidated balance-sheet, supported by a consolidated balance-sheet of foreign subsidiaries; and there is a growing practice of submitting pertinent explanatory comments relative to currency restrictions, trade limitations, reinvestment policies, foreign taxes, domestic taxes upon transfer of profits and other factors, any one or more of which may be material in a given case.

To the extent that earnings of such foreign subsidiaries justifiably may be included in the equity expressed in the consolidated balance-sheet of the parent and in the related consolidated statement of income, the surplus of the consolidated parent group will be affected in like amount, but such additions to surplus probably should be separated from consolidated earned surplus as "undistributed earnings of unconsolidated subsidiaries," with accompanying notes relative to availability, etc. When there are accumulated losses since acquisition of particular subsidiaries, however, the trend is toward the deduction of such losses from earned surplus, although many merely use an explanatory footnote.

On the other hand, there are notable instances of utility holding companies whose principal investments are in foreign subsidi-

aries. In such cases, the single balance-sheet and statement of income of the parent, supported by consolidated statements of the parent and subsidiaries, both accompanied by pertinent explanatory notes, would seem to offer the best solution. In some cases the consolidated balance-sheet has been omitted whereas the consolidated statement of income has been published.

Fixed assets and intangibles:

The cost of fixed assets on the books of a subsidiary is not necessarily cost to the parent, and the cost or other basis of fixed assets appearing on the books of the seller probably has no relation to the utility of such fixed assets to the purchaser. Accordingly, appraisal at the time of acquisition of the subsidiary would seem to afford a practical basis of determining such amounts.

The term appraisal is not restricted to the commonly accepted meaning of "sound value", i. e., replacement cost, less observed depreciation (although that basis might be pertinent), but is intended to refer primarily to utility in the sense of the price which the buyer would be justified in paying for such fixed assets if the negotiations were not influenced by considerations of intangible values. This is the maximum cost of such assets to the purchaser. The cost may have been less, but if ostensibly more, the excess relates in fact to intangible values.

It is impracticable, if not impossible, in many cases to adjust historical book amounts of fixed assets to this basis, and it may be equally impracticable to restate the fixed assets of a single company on a uniform and technically consistent basis. The problems are basically the same, however, in the case of the single company and in that of consolidation. One should be wary of describing the basis of stating the amount of fixed assets as "cost" without adequate qualification in either case, unless the facts are unassailable. Explanatory notes accompanying the balance-sheet afford the means of making the statement more informative in this respect.

Intercompany profits:

The abstract principle of elimination of intercompany profits is simple, contemplating the exclusion of potential profits from consolidated inventories and from consolidated earnings until realized by disposition of product to purchasers beyond the circle of related companies. The practical application of the principle,

however, involves numerous entanglements. When inventories have been adjusted to market lower than cost, there remains no intercompany profit to be eliminated, providing market refers to replacement cost to the seller within the affiliated group and not to the purchaser within such group.

It is clear, when a parent sells goods to a subsidiary at a profit, that such profit is not realized from a consolidated standpoint until such goods pass to an unrelated purchaser. Such unrealized profits are reflected on the parent's books and should be treated in reduction of consolidated inventories in the consolidated balance-sheet. So far as part of such intercompany profit is reflected in the inventory on the subsidiary's books, it will be eliminated from consolidated inventories in the consolidated balance-sheet, and the current intercompany accounts between the parent and subsidiary, likewise, will be eliminated in the consolidation. On the other hand, if the subsidiary has sold goods to the parent or another affiliate at a profit, the vender subsidiary has an unrealized profit from the standpoint of consolidation to the extent that the related goods are present in the inventory of its affiliate, and the consolidated accounts must provide for the elimination of such intercompany profit.

It is argued by some that the minority interest in a vendor subsidiary is entitled to credit for its full share of earnings based upon legally binding sales between corporate entities, and that consolidated inventories should be reduced only by the unrealized profit related to the majority interest. This view ignores the single-company theory of consolidated statements, upon the basis of which the inventory should be reduced by 100 per cent. of the intercompany profit, and in general practice that procedure is followed. In fact, the reserve for intercompany profit usually is provided in its entirety on the parent's books as a matter of simple expediency. The minority interest is not being deprived thereby of its ultimate rights in profits realized through sales beyond the affiliated group. For its legal interest in the subsidiary, the minority must look to the separate balance-sheet of that company.

A different aspect of the subject is presented when the inventory of a subsidiary includes products sold by it to the parent or other affiliate prior to the time at which such subsidiary became a member of the consolidated group. Surplus of the subsidiary at date of acquisition by the parent includes profits determined on

the basis of such transactions. However, under the "single company" theory of consolidation, all intercompany profits should be eliminated from consolidated inventory, and the related charge should be made against the surplus of the subsidiary at acquisition, because such profit is not realized by the consolidated group until reflected in sales beyond the affiliated group.

These examples are symbolic of many complexities in the practical application of the principle of elimination of intercompany profits, which are often of substantial importance and lead to divergent views among accountants. Attempts to dogmatize raise innumerable exceptions. While formal doctrine may be stated as a general rule, it should remain flexible, and each case should be weighed in the light of related circumstances. Misconstruction may be avoided by a candid exposition of the principles applied in cases involving material fact.

Consolidated earned surplus:

As a class the problems relating to consolidated earned surplus arise out of the endeavor to subject them to the legal construction of surplus available for transfer to the parent and relate to such subjects as subsidiary deficits at acquisition, stock dividends of subsidiaries, sinking-fund and stock retirement provisions, indenture restrictions concerning maintained ratios of net quick assets, etc., all of which may be answered by the general statement that such considerations would affect a single company as well as an affiliated group and would not prevent the inclusion of the company's entire earnings in its published statement of income, but they may require segregation or other earmarking of surplus in the consolidated balance-sheet, just as in the case of a single company.

Stock of parent acquired by subsidiary:

It sometimes happens that a subsidiary acquires shares of the common stock of its parent, and cases have been noted where substantial holdings have been purchased at a time when the parent itself legally could not have done so. The subsidiary may have had the legal right to make the purchase, but the problem of consolidation presents the paradox of a constituent company which has purchased stock of the parent which in the consolidated balance-sheet may lend the appearance of an illegal reacquisition.

While the statutes of the states vary, it may be said to be a basic legal principle that a corporation has the right to acquire its own stock only to the extent of the excess of its assets over the sum of its liabilities and stated capital, i. e., to the extent of surplus of all classes, including capital surplus. This rule follows the reasoning that the stated capital of a corporation constitutes a trust fund for the protection of creditors which may not be reduced (except by losses) without giving statutory notice of such change by filing with the secretary of state a certificate of reduction of issued capital stock.

When a corporation acquires its own stock, the effect upon capital may be reflected in the balance-sheet by earmarking surplus by one of several methods: (a) an actual appropriation of surplus, (b) a parenthetical explanation in the description of surplus or (c) a footnote. In certain types of preferred stock, subject to serial redemption, there are sometimes provisions pursuant to which an actual appropriation of surplus may be mandatory. When a certificate of reduction of issued stock is duly filed, the necessity for earmarking is removed so far as the basic legal concept is concerned, but in cases involving contractual commitment as in the types of preferred stock previously described,. continued appropriation or earmarking may be necessary. It is only in recent years that a growing tendency to disclose the effect of treasury stock upon surplus has been apparent.

Some eminent lawyers have questioned the traditional practice of deducting treasury stock directly from capital stock issued, maintaining that the extended figure of capital stock should always be the legal "trust fund" amount and that treasury stock should be deducted from the sum of capital stock and surplus, thereby indicating that stated capital is not directly affected by such acquisition but that the combined capital stock and surplus are affected, thus earmarking surplus as having been applied to such acquisition of treasury stock. If this theory were followed the amount of the parent's stock held by the subsidiary would be treated in the consolidated balance-sheet as a deduction from the sum of capital stock and surplus, and described as stock of the parent held by a subsidiary.

Restrictions in bond indentures:

The importance of explanatory notes and careful segregation of accounts may be illustrated by the hypothetical case of a subsid-

iary having funded debt, with an indenture requiring the maintenance of a minimum current ratio, making it impossible for the subsidiary to advance cash to its parent which has defaulted on its own bonds. Were the consolidated balance-sheet to include in general cash the substantial cash balances of the subsidiary, without explanatory comment, the consolidated balance-sheet would show no apparent reason for the default of the parent.

In such circumstances careful consideration must be given to the manner in which the material facts should be displayed, either by earmarking cash or excluding the company from the consolidation and submitting separate statements of the subsidiary, with pertinent explanatory notes in either case.

Unconsolidated Statements

The present requirements of stock exchanges, the securities and exchange commission and others for unconsolidated statements of parent companies, in addition to consolidated statements, necessitate some reconsideration of the problem of making such unconsolidated statements independently informative to the extent that reasonably may be possible by the disclosure of material facts which may be expressed more clearly in consolidated statements.

It has been the consistent practice of some corporations to increase or diminish their investments in subsidiaries by the proportionate share of the profits or losses of such subsidiaries. Such appreciation is included by footnote in the parent's statement of earnings and is credited to "undistributed earnings of subsidiaries since acquisition" as a separate division of surplus or as a deferred credit. Losses of subsidiaries which previously have had undistributed earnings since acquisition are treated as reductions of previous appreciation to the extent of remaining undistributed net earnings of the subsidiary since acquisition, whereas shrinkages of investment under cost, resulting from such losses, are treated as direct charges against the parent's earned surplus. On the other hand, subsequent earnings of such subsidiaries are reflected in credits to earned surplus of the parent to the extent of related losses previously charged thereto. This method discloses the parent company's equity in subsidiaries, excludes undistributed earnings of subsidiaries from the parent's earned surplus until realized in the form of dividends, but absorbs in the parent's surplus the net losses of subsidiaries in the

same manner as the decline in ordinary marketable securities would be reflected in earned surplus. In theory, this procedure is sound; and in the average case it is practicable.

Many parent companies carry investments in subsidiaries consistently at cost of acquisition or amounts established otherwise at inception. Although, under this method, profits of subsidiaries are not taken up on the parent's books, it is contended by many that net deficits of subsidiaries should be taken into the parent's earned surplus but may be offset by subsequent profits of the subsidiary until such losses are eliminated. On the other hand many prefer to express the pertinent facts by footnote. When unconsolidated balance-sheets reflect investments in subsidiaries at cost, involved explanatory notes may be needed to reconcile such investments with the equities shown by the books of subsidiaries. In each case, it may be advisable to state the principles observed by the parent relative to (a) the basis of stating the amount, (b) policy as to inclusion or disclosure of profits or losses of subsidiaries and (c) treatment accorded dividends from subsidiaries. When profits or losses are not taken up, amounts should also be stated in such explanatory notes.

It is interesting to note that the uniform accounting methods prescribed by the securities and exchange commission pursuant to the public utilities act of 1935 require holding companies to carry investments in subsidiaries consistently at cost without adjustment for undistributed profits. While the rule undoubtedly is intended to prohibit the inclusion of undistributed earnings of subsidiaries in the parent's earned surplus, it also precludes the adoption of the procedure whereunder such subsidiary profits could be credited to a separate division of surplus entitled "undistributed earnings of subsidiaries," thereby earmarking them as unavailable for distribution by the parent. It is improbable that this prohibition will be extended to companies other than utilities, because the prescribed accounting is peculiar to the purpose of the public-utility act of 1935, seeking to prevent abuses, actual or alleged, which were discovered by the federal trade commission investigations.

It is interesting to observe that in May, 1936, the securities and exchange commission promulgated a ruling concerning unconsolidated foreign subsidiaries, in registration statements, to the effect that no financial statements need be furnished as to such a foreign subsidiary when all of the following conditions exist:

(1) "A specific reserve against loss on investments in and advances to such foreign subsidiary has been established in an amount substantially equal to the amount at which such investments and advances are carried;

(2) "During the period for which profit-and-loss statements are filed, no income has been taken up by the registrant directly or indirectly from such foreign subsidiary;

(3) "Such foreign subsidiary is organized and does the principal part of its business in a country from which, on account of governmental restrictions, the withdrawal of income is prohibited or seriously impeded."

The ruling contemplates that, in such cases, a note shall be added to the balance-sheet stating that financial statements have been omitted because the circumstances came within the provisions mentioned. The note should also show the amount of the investment in and advances to such subsidiary and should state the date and source of the reserve provided against such subsidiary. If more than one foreign subsidiary be so omitted, the information may be given for the group as a whole.

The registration instructions provide for elaborate detailed schedules of investments, requiring the separate presentation of major investments, although reasonable grouping without enumeration is permitted as to other investments.

"In respect of unconsolidated subsidiaries, the registrant's proportion of the difference between current earnings or losses and the dividends declared or paid must be shown by footnote or otherwise on the consolidated profit-and-loss statements and the related increase or decrease in the registrant's interest in such unconsolidated subsidiaries must be shown on the consolidated balance-sheet."

A schedule is also required in support of each profit-and-loss statement submitted, showing income from dividends as follows: (a) title of issue and name of issuer, (b) amount of dividends in cash or otherwise and (c) amount of the registrant's equity in the affiliates earnings, or losses for the period, where applicable. Dividends other than cash must be described, and the basis of the credit to income must be disclosed as well as the reasons for such treatment. The stocks of affiliates must be listed or combined as shown in the schedule of investments. The profit-and-loss statement requires the separate disclosure of dividends and of interest on securities of affiliates.

IN CONCLUSION

The principles of reasonable disclosure apply with equal force to both listed and unlisted companies, whether large or small, and the body of precedent reared by the rules and decisions of the commission and observed by registrants in reports filed pursuant to the securities and exchange acts probably will influence, in due course, the courts in cases which do not come within the jurisdiction of the commission.

It is noteworthy that while the regulations, rulings and decisions of the commission create precedent concerning fair disclosure of material facts, these findings do not wholly allay the misgivings arising from the requirements of the law that all material facts be disclosed. Many affected by the liabilities imposed by the acts continue to demand amendment of the law enumerating specific disclosures, be they ten or ten hundred. The attitude of the commission, on the other hand, seems to be that requirements in the underlying law calling for specific disclosures would create inflexible standards inapplicable in many cases and, on the other hand, would exclude disclosures manifestly material although peculiar to other cases. There is obvious merit in both views.

It may be said, sincerely, that the suggestions emanating from the commission and its technical staff, incident to the review of registration statements, have sought to protect registrants, underwriters and experts from inadvertent or deliberate omission of data considered material by the commission, although occasionally the arguments may have seemed strained. The commission appears willing to accept what is an apparent consensus of opinion among accountants concerning sound principles. Behind this attitude, however, there lies a warning that, in the event of disagreement among accountants, the commission will determine principles for them.

While the requirements of the commission concerning consolidated statements are exacting, and may be thought by some to exceed reasonable limits in the volume of data required, the underlying principles are indisputably sound and provide adequately for judgment and flexibility in the presentation of material facts as they may appear in individual cases.

Unless the securities legislation is amended substantially, it probably will play an increasingly important part in crystallizing opinion relative to sound practices in the preparation of consoli-

dated statements. It is noteworthy that the New York stock exchange has issued letters to listed companies requesting the publication of financial statements in the form accepted by the securities and exchange commission.

The profession has developed its position on these matters soundly but slowly. Perhaps some acceleration of the process may be expected within the profession, now that its hand has been strengthened by the securities and exchange commission. The public accountant knows the peculiarities of his clients' accounts and should advise them on questions involving the technique of presentation. It is not only a matter of academic interest but one of practical importance, vital to the protection of the clients' interests in the disclosure of material facts in accordance with recognized practices.