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DISSEMINATION

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By

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* * * * *

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CHAPTER I

INTRODUCTION

The provision of information for financial reports is one of the important functions of a system of accounting. The accounting profession is constantly engaged in efforts to improve upon the content and form of such financial reports. This study is confined to an examination of but one phase of the presentation of financial reports—combined financial reports of two or more related but separate corporate entities. It is further limited to whether such statements should be prepared, with no attempt to determine how they should be prepared.

The Problem

Combined financial statements have long been recognized as a method of exhibiting the financial position and operating results of an economic entity composed of two or more legally separate but commonly owned business enterprises. An accumulation of theory in regard to such statements has been developed.

Included in the body of theory are certain principles which are generally accepted by accountants. They are apparently consistently followed in the presentation of combined statements. These principles relate to the techniques of preparation of the statements. There is a lack of consistency, however, in the policies of corporations
in their selection of the affiliated companies which appropriately should be included in the combined statements.

This study entails an examination of the criteria for the preparation of combined financial statements. It further attempts to delineate the circumstances in which the preparation of combined financial statements would be essential to the interests of clarity and consistency in financial reporting.

Definitions of Terms Used

There are contradictions and overlapping meanings in the language of business. In the interest of consistency, the terms herein used to describe certain intercompany relationships are as defined in Kohler's *A Dictionary for Accountants.* Following are definitions of those which are critical to the recognition of the distinctions between various corporate associations:

**Affiliate.** A corporation related to another by owning or being owned, by common management, or by any other control device.

**Associated company.** A corporation exactly 50 per cent of whose voting capital stock is owned by another.

**Consolidated financial statement.** A statement showing financial condition or operating results of two or more associated enterprises as they would appear if they were one organization.

**Parent company.** A controlling corporation having subsidiaries.

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2. Ibid., p. 24.  
3. Ibid., p. 37.  
4. Ibid., p. 98.  
5. Ibid., p. 306.
Subsidiary company. A corporation owned or controlled by a holding or parent company, most often through the ownership of voting stock.\textsuperscript{6}
CHAPTER II

THE APPLICABILITY OF CONSOLIDATED FINANCIAL STATEMENTS

In the present economic climate, there is an increase in the scope of ownership of corporate equity securities. It is no longer proper to refer to corporate ownership as being that of wealthy industrialists. The amount of stock owned by people of modest means has grown rapidly in recent years. It is logical to assume that such growth will continue.

The reasons for widespread interest in common stocks are many and varied. However, among the most important of those reasons, two would appear to predominate: (1) increased familiarity with stocks and the methods by which they may be acquired and (2) an attempt to counter the effects of inflation by an investment which tends to change value in a direct relationship with the value of the currency.

The first of these reasons has been fostered by the corporate entities themselves and by the securities exchanges and their member firms. The former have done so with the intention of stimulating the employee's interest in and concern for the company for which he works and, too, as part of an attempt to mitigate the effect of income taxes on employee earnings. The latter have done so, for the obvious purpose of selling securities, through the various plans for regular investment of relatively small dollar amounts.
The second reason may very well stem from the first. Too, it may prove to be fallacious. But common stocks as a hedge against inflation are attractive because they may be acquired in relatively small dollar amounts and in as wide a variety of industrial ventures as the desires of the investor and the total amount of dollars he wishes to invest might dictate.

Separation of Ownership and Management

Concurrent with the widening ownership of corporate stock has been a decline in large holdings of stock in the same corporations. Individual holdings have been reduced as a result of income tax and death tax implications. Family and institutional holdings have tended to be reduced in conformity with policies of diversification and changing investment philosophies. As a result ownership of corporate stock tends to be divorced from management of the company.

This separation of corporate ownership from direct operation of the company has had two important effects on the large corporate organization. First, corporate management has become professional in nature. Executives are apt to own only a small percentage, if any, of the outstanding stock of the company whose policies they control. They are perhaps as sensitive to public opinion of corporate activities as they are to the desires of the stockholders. Second, the management is likely to be self-perpetuating. A stockholders group composed of several hundred thousand owners, each with a few hundred or less shares of stock, can be expected to be disorganized and apathetic. Once in control, a management group can normally expect to remain unless
indications of gross mismanagement precipitates a fight for control by a group of militant stockholders.

The average stockholder, then, takes no part in the determination of policy of the company in which he owns stock. He is unlikely to attend annual stockholder meetings because of the inconvenience and cost of being present at the place and time for such meetings. In the case of the larger, more widely owned companies, no meeting place would accommodate all the stockholders. The average stockholder can keep informed as to the activities of his corporation only through the medium of the reports prepared by and about the corporation and made available to the stockholders.

The Importance of Corporate Annual Reports

The primary means of communication of the activities of a corporation to its stockholders is the corporate annual report. Other sources of information would be the various reports required to be filed by the corporation with the Securities and Exchange Commission and the publications of the statistical reporting services, which obtain much of their information from reports filed with the SEC.

The annual report is designed by the management of the company to portray the past year's activities in their most favorable light. It usually contains optimistic references to the future of the company. The report is the vehicle by which the board of directors attempts to sell its services to the stockholders for the years to come. In many cases it is only incidentally concerned with a
reporting of financial information. The financial statements and the auditor's opinion letter are usually placed on the last few pages of the report.

The information available to interested parties concerning a given corporation is far more complete in the statistical services and the public records of the SEC than in the usual annual report. This is particularly true of background data of a historical, non-financial nature. However, to the average investor the financial data contained in the annual report probably appears complete. In addition, to one not skilled in the fields of finance and accounting, the very quantity of material available in the statistical services and SEC reports may be a barrier to reference to it. Thus the very purpose for which the SEC was brought into being, protection of the investor, may be defeated by the completeness of the information which it causes to be made available.

The efforts of the accounting profession have been directed from the beginning toward presenting the financial position and result of operations of a business firm in a straightforward and useful form. Concern with the effects of the collapse of the stock market at the end of the 1920's caused such efforts to be increased. In recognition of the authority granted to the Securities and Exchange Commission, under the Securities Act of 1933 and the Securities and Exchanges Act of 1934, the accountants have endeavored to formulate generally accepted accounting procedures and reporting standards. This has been and is being done principally through the American Accounting Association and the American Institute of Certified Public Accountants, and with the cooperation of the SEC.
One of these organizations, the American Accounting Association, in June of 1941 issued a statement of principles as a guide to accountants. It was prefaced by what was called "The Basic Assumption":

The purpose of periodic financial statements of a corporation is to furnish information that is necessary for the formulation of dependable judgments. A knowledge of the origin and expiration of the economic resources of a company and the resultant changes in the interests of its creditors and investors is essential to this purpose, and these facts should be expressed in such a manner as to make the financial statements both intelligible and, as far as possible, comparable with statements of other periods and of other corporations. The reader of a statement should be able to assume that, in the absence of clear indications to the contrary, certain basic principles or standards have been followed. To achieve this end, a unified and coordinated body of accounting theory is required.\(^1\)

This was and still is a succinct description of the ideal standards for preparation of corporate annual reports. It was developed during the late 1930's, undoubtedly after much discussion and reworking, and its authors could not foresee the economic development which have since made it difficult to implement.

**The Inevitability of Corporate Expansion**

The amount of business growth and expansion during and following World War II has been far greater than economic conditions in the 1930's would have warranted. It is apparently the destiny of a successful business firm to increase in size. Why this is true is not the purpose of this study. Observation of business progress generally indicates that it is true.

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\(^1\) Executive Committee, American Accounting Association, "Accounting Principles Underlying Corporate Financial Statements," *The Accounting Review*, XVI (June, 1941), 134.
Business expansion may take one or a combination of three possible forms. A single firm may increase in size by internal growth, multiplying the number of plants and establishing new divisions to concentrate on various phases of business activity. A second vehicle for expansion is the combining of two or more existing companies by means of a statutory merger or consolidation resulting in one successor company. In this instance one, or more, of the predecessor companies loses its identity completely or becomes merely one division of the resulting larger company. The third form of expansion is the parent-subsidiary relationship with one dominant company owning or controlling one or more other separate legal entities. This may be accomplished by acquiring the stock of an already existing corporation or by forming a new company.

This study is concerned with the latter form of business expansion. It is not an attempt to justify this corporate relationship or to criticize it. The only interest here is in the financial reporting for this form of business combination. There should be consistency of presentation of financial data, for this and other corporate forms, which is comparable from company to company, whatever the chosen method of accomplishing expanded business operations.

The Purpose of Consolidated Financial Statements

The combination of separate legal entities by the device of the holding company or parent-subsidiary relationship was first used in the late 1800's. According to Bonbright, the American Bell Telephone Company, which is now the American Telephone & Telegraph Company, was empowered by a special act of the Massachusetts legislature in 1880
to own stocks of other telephone companies. And in 1888 the corporation law of the state of New Jersey was amended to make it possible for all corporations formed in that state to include in their charter the specific power to hold stocks in other companies. Since that time most of the states have legalized the ownership by a corporation of the stocks of other corporations.

Once the ownership of the stock of one corporate entity by another became legally possible a means was devised of portraying the operating results or financial position of the related companies as though they were one. This device is the consolidated financial statement. One of the earliest, if not the earliest, uses of this financial statement form was by the National Lead Company in 1892. The use of consolidated statements, then, became an accepted practice about 1900. There has been much written and said about such statements in an attempt to define a set of principles for their preparation and use. Since, as was indicated above, two national organizations of accountants, the American Accounting Association and the American Institute of Certified Public Accountants, and an agency of the federal government, the Securities and Exchange Commission, have been most influential in the development of standards for financial reporting,

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3Ibid., p. 404.

it would be appropriate at this point to examine the attitude of each toward consolidated statements.

The Position of the SEC

The Securities Acts of 1933 and 1934 and the Holding Company Act of 1935 provided that the SEC might prescribe, for companies required to file reports with that organization, the use of separate and/or consolidated financial statements. In each case the Commission has the right to determine which method of presentation most clearly presents the financial position and operating results of the registrant. A number of the Accounting Series Releases issued by the SEC have dealt with acceptable methods of presentation and the appropriateness of consolidated statements.

Rule 4.02 of Regulation SX states:

The registrant shall follow in the consolidated statements principals of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the registrant and its subsidiaries . . .

This would tend to indicate that in some if not most cases consolidated statements would be the only acceptable method. It is apparent from examination of individual cases of registration with the SEC that that organization does require consolidation of subsidiary companies even though the registrant may be inclined toward non-consolidation. The Chief Accountant of the SEC has indicated that "friendly persuasion"

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6 Ibid., p. 266.
is resorted to in cases where there is a difference of opinion with no weight of accepted practice on either side.

Rule 4.03 of Regulation SX provides that,

For majority-owned subsidiaries not consolidated with the registrant there may be filed statements in which such subsidiaries are consolidated or combined in one or more groups pursuant to principles of inclusion or exclusion which will clearly exhibit the financial position and results of the group or groups. If it is essential to properly summarized presentation of the facts, such consolidated or combined statements shall be filed.7

and Rule 4.05 (b) requires:

A statement shall be made of the amount of any difference between the investment of the parent and consolidated subsidiaries, as shown by their books, in the unconsolidated subsidiaries and fifty-percent owned persons for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, and fifty-percent owned persons, as shown by the books of the latter.8

Thus the SEC attempts to reconcile the conflict between the advantages of clarity of financial relationships which the consolidated statements can provide and the generally accepted standards for their preparation.

The SEC clearly recognizes the appropriateness of consolidated financial statements to portray the position and results of a group of related companies. It has the authority, for the purpose of reports required to be filed with it, to insist upon consolidated statements where accepted accounting procedures might not make such consolidation necessary. And even where the SEC does not insist upon consolidated statements, it does require that information be furnished which will permit interested persons to determine the effects on net assets and net earnings which consolidated statements would have shown.

7 Ibid., p. 271. 8 Ibid., p. 273.
It appears, therefore, that the SEC considers consolidated statements the preferred form for reporting for a group of related companies.

The Attitude of the American Accounting Association

The first concerted effort by the American Accounting Association to develop generally recognized standards of reporting was made in 1936. The Executive Committee of the Association authorized and a majority of the members of the Association's Advisory Committee approved the publication in The Accounting Review of "A Tentative Statement of Accounting Principles Affecting Corporate Reports." The opening paragraphs contained the following statement:

The most important applications of accounting principles lie in the field of corporate accounting, particularly in the preparation of published reports of profits and financial position . . .

Every corporate report should be based on accounting principles which are sufficiently uniform and well understood to justify the forming of opinions as to the condition and progress of the business enterprise behind it.\(^9\)

The statement was limited in nature, making no reference to consolidated statements as such, and was issued with the stated purpose of arousing discussion.

The following year the Executive Committee directed a member, Eric L. Kohler, to conduct a study of consolidated statements. A paper was presented by Mr. Kohler at the December 1937 meeting of the Association and later issued as representing the opinions of the

Committee. Consolidated statements were apparently considered a temporary expedient:

The objectives in presenting financial results should be clarity, sufficiency, and comparability, with the general qualification that until the requirements of financial interpreters can be formulated more precisely, an oversupply of information is to be preferred to the meagre details so frequently accompanying controlling-company reports.\(^\text{10}\)

The legal status of such statements was questioned:

Both the strength and the weakness of a consolidated statement lie in its ability to disclose summary information about a number of related enterprises, with a fine disregard for legal entities. This disregard is essential to the concept of an economic unity but it may be the source of confusion to creditors and other equity holders.\(^\text{11}\)

And consolidated statements were relegated to the status of reports supplementary to the single-company statements:

Combined financial statements portray the joint position or operating results of two or more business or other units as though but one existed. They are secondary rather than primary in character, and, as enlargements of the financial statements of a common controlling interest, they assist in explaining the relationships of that interest to the outside world.\(^\text{12}\)

This, then, was the agreed attitude of at least a majority of the leading members of the Association at that time.

In 1944, the Association published a monograph by Maurice Moonitz which dealt with consolidated statements. The monograph followed, in part, very closely the views expressed earlier by Kohler.


\(^{11}\) Ibid. \(^{12}\) Ibid.
In regard to the legal status of such statements and their relative importance, Mr. Moonitz indicated:

... When preparing the consolidated statements of a group of related corporations, we are dealing with an entity almost wholly, though not entirely, outside the scope of complete legal recognition... Because of the limited status in the eyes of the law of the entities to which they refer consolidated statements must be regarded as auxiliary, special-purpose reports, not primary, all-purpose exhibits supplanting or displacing the statements of legally recognized entities.\(^13\)

He pointed out that creditors of subsidiaries had no interest in consolidated statements unless the parent company was a guarantor of repayment. Management, on the other hand, had a definite interest in such statements:

As the agency in direct control of the affairs of the combination management must have data concerning its functioning. Information of this nature will be obtained from many sources; but the major source of the type of data expressible in financial terms is a set of consolidated statements of the group as a whole. To management these statements tend to appear as primary in character; statements of the operations of constituent units then fulfill the function of schedules supporting the principal generalized presentation.\(^14\)

And recognition was given to the importance of consolidated statements to the owners of the parent company:

To what extent stockholders are really informed by means of conventional reports is a question pertinent to the whole field of corporate accounting practices. In accordance, however, with the canon that present and prospective shareholders are entitled to a full report on their field of investment, regardless of the use they may make of


\(^{14}\)Ibid., p. 16.
the data, it is concluded that consolidated statements are essential components of a complete accounting. From a long-range point of view a consolidated report is undoubtedly superior to a statement of the dominant company taken alone.\(^\text{15}\)

In the Foreword to the monograph, the Committee on Monographs of the Association denied any responsibility for the author's views or recommendations. As to the relative importance of consolidated statements versus single-company statements the Committee pointed out:

Dr. Moonitz . . . views consolidated statements as "secondary rather than primary in character," as "supplemental to, rather than as substitutes for" the statements of the constituent corporations. There are, of course, some areas of disagreement and difference in emphasis.\(^\text{16}\)

In 1946 a special committee of the Association began work on a revision of the statement of Accounting Principles Underlying Corporate Financial Statements issued in 1941. This committee has since issued a number of supplementary statements amplifying certain selected points. Supplementary Statement No. 7, issued in 1954, dealt with the area of consolidated financial statements. As a "Basic Principle" the committee stated:

In the absence of special circumstances, consolidated statements are useful representations of financial position and results of operations when a dominant central financial interest in two or more companies exists and is accompanied by administrative control of their activities and resources.\(^\text{17}\)

\(^{15}\text{Ibid., p. 16.}\) \(^{16}\text{Ibid., p. vi.}\) \(^{17}\text{Committee on Concepts and Standards, American Accounting Association, "Consolidated Financial Statements, Supplementary Statement No. 7," The Accounting Review, XXX (April, 1955), 194.}\)
In discussion of this principle, the committee gave recognition to the widespread adoption of the consolidated statement in corporate annual reports:

During the past half-century, consolidated statements have constituted an increasing proportion of the published financial reports of American corporations. Furthermore, the tendency to present consolidated statements alone, unaccompanied by the separate statements of constituent companies, has increased. These trends strongly imply that the consolidated statements are more useful than the separate statements, and may now be primary rather than secondary or supplemental.\(^\text{18}\)

While the statements of this committee were not official pronouncements of the Association or its Executive Committee, they did reflect the judgment of at least two-thirds of the committee members. One of the members of the committee when the above statement was issued was Maurice Moonitz whose earlier thoughts are indicated above.

It would appear that the American Accounting Association generally accepts the consolidated form as appropriate for published financial statements. If the position of the Committee on Accounting Concepts and Standards reflects the opinion of the Association members generally, consolidated statements are the primary form for presenting corporate financial information where a dominant financial interest exists in two or more companies. If the point in "The Basic Assumption," contained in the statement issued in 1941, is still valid corporate statements should be "comparable with statements of other periods and of other corporations."\(^\text{19}\) Then it would be proper to assume

\(^{18}\) Ibid.

\(^{19}\) Executive Committee, American Accounting Association, "Accounting Principles Underlying Corporate Financial Statements," The Accounting Review, XVI (June, 1941), 134.
that the position of the Association is that the only appropriate form of financial report for a group of related corporations is the consolidated form.

The Attitude of the American Institute of Certified Public Accountants

The American Institute of Accountants undertook the task of endeavoring to establish a body of uniform standards of corporate reporting concurrently with the American Accounting Association. In 1929, the Institute had prepared, and issued under the auspices of the Federal Reserve Board, a bulletin which dealt with procedural matters in the examination of corporate financial reports. As a result of discussion and correspondence with the New York Stock Exchange from 1932 to 1934, a special committee was appointed by the Institute to revise and widen the scope of the 1929 bulletin. In January 1936, the Executive Committee issued the revised bulletin.

The introductory sentence on the subject of consolidated reports indicated the special committee's opinion of the appropriateness of such statements:

It has been rather generally accepted that the position and earnings of a parent company and its subsidiaries as a whole usually can best be presented by means of consolidated statements showing the combined position and operations of the group.

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22 Ibid., p. 5.
The question of whether consolidated statements were of primary or secondary importance was not definitely answered. The decision was left to the person preparing the statements:

... The general rule is that, when power to control is present, that principle of inclusion or exclusion should be followed which will most clearly exhibit the financial condition and results of the parent company and its subsidiaries.23

And the possible shortcomings of such statements were given recognition:

The limitations of consolidated financial statements should be recognized. The status of bondholders and other creditors and the respective assets against which their claims rank may not be shown, and thus consolidated statements may be inadequate unless accompanied by additional statements. The necessity of giving further statements for the parent company alone, and possibly for certain subsidiaries, should be considered, particularly the balance sheet.24

The Committee on Accounting Procedure has continued the work of the special committee, referred to above, since 1938. From 1939 to 1959 a total of fifty-one Accounting Research Bulletins have been issued by this committee. These Bulletins have been designed as guides to the accounting profession in the interest of consistent financial reporting. Only two of these bulletins have dealt directly with the appropriateness of consolidated reports.

The first reference was in ARB No. 4 (Special) issued in December 1939. Concerned with disturbed conditions in foreign countries, the Bulletin was entitled Foreign Operations and Foreign

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23 Ibid., p. 5. 24 Ibid., p. 6.
Exchange. It contained the following statement of the Committee's opinion:

It is clear that in many cases in which statements of foreign subsidiaries have been consolidated with statements of United States companies this practice can no longer be followed.25

The Bulletin further suggested alternative procedures which might be followed in presenting the financial information for a group of companies, some of which were located in foreign countries. While not concerned primarily with consolidated reports, the Bulletin did re-affirm recognition of their appropriateness as a reporting device.

Until 1959 the Institute made no further direct reference to the circumstances in which consolidated statements would or would not be appropriate. In Accounting Research Bulletin No. 51, the Committee on Accounting Procedure began with the following observation:

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 where one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.26

Thus the Committee rather definitely established the importance of such statements for reporting purposes. Elimination of the word "usually"


would leave no doubt as to the recommended course of action for mem-
bers of the accounting profession.

Requirements of the Stock Exchanges

The New York Stock Exchange, concerned with the causes of the
"crash" of stock prices in 1929, has affected the practical applica-
tion of uniform procedures to corporate reporting. As indicated
earlier, the New York Stock Exchange had an important hand in the
bulletin issued by the American Institute of Accountants in 1936.27
In their application forms required to be filed by a company desiring
to list its securities on the exchange, both the New York Stock Ex-
change and the American Stock Exchange require:

(1) A summarized statement of earnings, on a con-
solidated basis, for the latest ten years,
(2) A consolidated income and retained earnings
statement for each of the last two fiscal years
with a consolidated balance sheet as of the end
of each of those two years, and
(3) If there are any subsidiary or controlled com-
panies not included in the consolidated state-
ments, footnotes indicating the parent company's
equity in undistributed earnings (or losses) and
the increase or decrease in equity of the parent

27 American Institute of Accountants, Examination of Financial
Statements by Independent Public Accountants, A Report Prepared by a
Special Committee (New York: American Institute of Accountants,
1936).
in the subsidiary's net assets since acquisition. 28

In the listing agreement required from each listed company, both Exchanges require that the corporation publish, at least once each year, either:

(1) A separate balance sheet, retained earnings statement, and income statement for that company as a separate entity together with the same statements for each corporation in which it holds directly or indirectly a majority of the equity stock, or

(2) Consolidated statements. 29

These stock exchanges, therefore, recognize the advantage of consolidated statements but leave to the accountants the determination of how they should be prepared.

Usefulness to the Financial Analyst

Writers in the field of corporate finance and security analysis generally make little or no reference to whether financial statements are consolidated or single-company statements. The usual reference to statements, of corporations where the parent subsidiary relationship obviously exists, is to the balance sheet or the income statement. By inference, then, they are referring to the consolidated statements. Where a distinction is made, the investor is advised that the


29 Ibid.
consolidated form is the more useful. The following statement is pertinent and is particularly interesting in regard to the usefulness of consolidated statements to creditors of one of the subsidiary companies:

A properly consolidated balance sheet is essential for the obvious reason that the statement of the parent company alone may give an entirely false impression of financial strength, both as to assets possessed and as an obligation outstanding against them. A subsidiary company, for example, may owe an obligation which would not be revealed in an unconsolidated parent company statement. Though theoretically such an obligation does not apply to the parent company when it has not been guaranteed, in practice the parent company may be expected to weaken itself in order to bolster a shaky subsidiary. It may be desirable to retain control of the business carried on by the subsidiary and there is also the question of the financial prestige of the parent company.³⁰

The trained accountant, certainly in a position to recognize alternative procedures which may be used for asset valuation and income determination and the effects of those alternatives, must exercise great caution in the analysis of financial statements. This is particularly true where footnotes are used, to the extent now popular, to supplement the information embodied in the statements themselves. On the part of security analysts and investors, untrained in accounting techniques as such, there must be a great reluctance to accept any information not contained in the statements or directly related thereto. They properly expect the accountant to present the financial reports of a company in their clearest and most complete form. That form is apparently that of the consolidated statement.

The Incidence of Consolidated Statements in Published Corporate Reports

It is apparent from examination of published corporate annual reports that consolidated statements are by far the predominant reporting method. In a survey of the annual reports of 600 selected companies having fiscal years ending in 1958, made by the American Institute of Certified Public Accountants, it was found that 525 of the companies had subsidiaries. Of those 525 companies, 496, or 94.5%, presented their statements in consolidated form.

Consolidated statements are usually the only financial statements presented in published reports. The Institute conducted a survey of consolidated statement practice of 329 companies which had presented consolidated statements in their 1954 annual reports. Of the 329, only five submitted single-company statements of the parent in addition to the consolidated statements. One of these companies discontinued the parent company statement in 1955. The question of whether consolidated statements are primary or secondary in nature would appear to have been answered in practice, at least. The primary reporting form for published reports of a group of related corporations is the consolidated form.

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The Innocence of the Investor

The average investor in corporate stock accepts rather than understands the term "consolidated." He is ordinarily not well versed in financial or accounting techniques or terms and nuances of meaning. He has heard that accountants are experts and he is conditioned to accept the decisions of experts in regard to his physical health, the maintenance of his home appliances and automobile, his insurance coverage, and many other necessities to his mode of living. He accepts the corporate report as prepared by an expert.

In addition, the independent certified public accountant's opinion letter, contained in each corporate annual report, states that the statements are prepared "in conformity with generally accepted accounting principles." The investor, therefore, has every reason to believe that the statements of Company X and Company Y, both in the same industry, reflect comparable information. He should be most perturbed to determine that varying interpretations of the appropriateness of consolidation of a given subsidiary company can result in variations in reported financial reports.

Summary

There is apparent unanimity of opinion that the financial position and results of operations of a dominant company and its affiliated companies are best portrayed in the form of consolidated statements. This is the stated opinion of those selected as representatives of the organizations most concerned with the development of proper financial reporting techniques. It is also the opinion reflected in the practice followed by the majority of those corporations having subsidiary companies and publishing annual reports.
There is, however, considerable variation in the completeness of the consolidation of subsidiary companies. A parent company may have two subsidiary companies. The consolidated statements may include the financial information of one subsidiary but exclude the other. The resulting statements are consolidated, it is true, but not as consolidated as would have been the case if both subsidiaries were included. The next chapter deals with the policies followed by corporations in the selection of which subsidiaries to include.
CHAPTER III

CONSOLIDATION POLICY

Recognition of the desirability of the use of consolidated financial statements and the practical adoption of them as a reporting technique preceded the formulation of generally accepted rules for their preparation. This is often true of developments in the financial world. As was indicated in the preceding chapter, the use of such statements is now generally accepted as an appropriate reporting technique. A body of theory as to the technical aspects of their preparation is still in the process of evolution.

Once the decision had been made to prepare financial statements in consolidated form, two fundamental problems needed to be solved. First, what related corporations should be included in the consolidated statements. And, second, what techniques should be applied to the financial data of the corporations included to properly portray the financial position and results of operations of the combined economic unit.

The second of these two problems has received the greatest amount of attention over the years. As a result, the techniques for accomplishing the mechanics of preparation of consolidated statements have become established, reasonably well refined, and fairly generally accepted. Minor variations are still found in practice. Adjustments of techniques need to be made from time to time to meet changing
conditions or correct previously unrecognized flaws. But in the main
the profession has the mechanical aspects of how to prepare the state-
ments nearly perfected.

The first of the two problems, selection of the companies to
be included in the consolidated statements, is the more difficult to
solve. Perhaps because of its difficulty, this aspect of combined
statement preparation has been given little attention and there is a
wide variation in its practical application. It is with this problem
that this chapter is concerned.

The Conditions Precedent

When consolidated financial statements were first introduced
as a reporting technique, the first of four recognizable periods of
active industrial combination was well underway. Led by the owner-
executives of the acquisitive companies, the "robber-barons" of
financial history, the mergers were aimed at attaining economies of
larger size and a monopoly position in the industry. Rapidly im-
proving communication and transportation systems and the development
of the technology of interchangeable parts made multiple-location
manufacturing operations possible and economical. The acquisition of
all or a portion of the stock of other companies, in this period, was
ordinarily aimed at eventual absorption of the acquired companies into
a larger industrial combination. The preparation of consolidated
statements, then, presented a "pro-forma" financial picture of what
in the future would probably be a single corporate entity.

This first merger period lasted from about 1880 to near the
end of the 1890's. As industrial firms increased in size, both through
internal growth and the combination of companies, the public began to fear the apparently monopolistic economic powers which such large companies might acquire. Public concern and the resulting political circumstances led to the passage of state anti-trust laws and to the Sherman Act of 1890. This legislation did not prevent statutory mergers and consolidations but did tend to reduce their number.

Depressed economic conditions from 1891 to 1893 caused public concern over "bigness" in corporate activities. Retrospect made the expanding economy of the previous years appear attractive. The climate for business combination once again was favorable and the second of the major merger periods began. Instigated by the financier-promoter group for the purpose of profiting by the sale of securities in new combinations, this period extended from about 1897 to 1903.

There was renewed public concern with the lessening of competition in the early part of the 1900's. Perhaps as a result, anti-trust action was brought against a number of well-known corporations. As an outstanding example, The Standard Oil Company of New Jersey in 1911 was held by the U. S. Supreme Court to be in restraint of trade.\(^1\) The Court caused the one company to be dismembered. The stockholders of The Standard Oil Company of New Jersey exchanged shares of that company for those of newly formed companies in 1912. The politico-economic climate for business expansion and combination was no longer good. And the investment opportunities of such corporate combinations had lost their allure.

\(^1\) *Standard Oil Company of New Jersey v. United States*, 221 U. S. 1 (1911).
The third flurry of corporate combinations began in the early part of World War I. Occasioned by the built-up demand for manufactured products, during and following the war period, and fostered by the favorable economic conditions of the 1920's, this period of merger and consolidation continued until 1929. While there was continued expansion of industrial firms and merchandising firms during this period, the major emphasis was in the field of public utilities. Because of the franchise and other controls developed to protect the public against the necessary monopolistic position of a public utility company and because public utility companies tended to be locally organized, locally financed, and locally controlled, outright merger or consolidation of such companies was unsatisfactory. The holding company, a device which had been used for industrial combinations to a somewhat limited extent, provided a better method of combination. And it also increased the attention which needed to be directed to the use of consolidated financial statements. Only by such a reporting form could the financial data of a group of related companies be understood.

Throughout these first three periods of corporate combination the acquisition by one company of a substantial financial interest in another was apt to be considered preparatory to the eventual merger or consolidation of the two. All or a majority of the outstanding shares of the acquired company were normally included in the original deal. If less than a majority of the shares were acquired at the outset, a relatively short time elapsed before majority ownership was achieved. Also, the firms combined during this period were usually engaged in the same production or marketing activity. Similarity of
activity, locale and method of operation made such combinations desirable for managerial purposes, as an aid to securing increased profitability.

The fourth period of extensive corporate expansion is the current one. It began in 1945, after the end of World War II, and is still in progress. The most active period was from the end of 1945 until the middle 1950's. For the most part, however, the nature of and impetus for this latest period of corporate expansion has differed from that of the first three. How and why this is so will be examined in later chapters of this study. The rationale for the development of the theory of consolidated financial statements lies in the propensity for eventual merger or consolidation of related companies during the three earliest periods of business combination.

Consolidation Policy in Theory

The consolidated statement form of report was born of necessity. The middle of the first period of corporate merger and consolidation and the amendment of corporate statutes to permit the ownership of the stock of one corporation by another were concurrent, dating about 1888. As was indicated in the preceding chapter, the National Lead Company presented its statements in consolidated form for the year 1892 yet the first discernible published material on the subject was an article by A. Lowes Dickinson in 1906.²

²Childs, op. cit.

There is a dearth of pertinent literature for the first forty years of the use of consolidated reports. That which is available is more concerned with the techniques of statement preparation than with consolidation policy, which Kohler defines as

the policy of a parent or holding company whereby affiliated companies are included in or excluded from consolidated financial statements appearing in published reports.4

This is not surprising, however, because for most of that period the acquisition of stock in one company by another was usually just one step toward the statutory merger or consolidation of the two companies. The circumstances which were later to occasion scepticism of the appropriateness of including a given subsidiary in the published consolidated statements had not yet begun to develop.

The rise in popularity of the holding company device for expansion during the 1920's, the stock market debacle of 1929, and questionable credit position of business firms in the early 1930's, all contributed to the recognition of the need for formalization of accounting procedures. Because of the uncertainty of the economic times and the dubiosity of the role the newly established Securities and Exchange Commission was to play in prescribing proper accounting for corporate reporting purposes, conservatism became the basic consideration. On this foundation the accounting profession began an attempt to establish a body of generally accepted accounting and reporting procedures.

The consolidation policy which could be considered acceptable received careful attention for the first time. Consideration was given to the recognition of the existence of borderline cases where inclusion of a given subsidiary in a consolidated statement might be misleading or perhaps misrepresentative of the true situation. The professional societies undertook studies designed to develop acceptable parameters for determining what sort of affiliated company might properly be included in consolidated financial statements of a corporation.

The earliest of these studies to be completed and published was that conducted by Eric L. Kohler for the American Accounting Association in 1937. The obvious and ideal circumstances where consolidated statements are appropriate were described:

Consolidated financial statements have more significance where the subsidiaries are homogeneous with the controlling company or with each other, and where the display of the financial or operating characteristics of any one subsidiary is not material to an understanding of the group as a whole. The strongest case for consolidated statements is the situation where a parent company and its wholly owned subsidiaries together constitute an integrated line of endeavor under a common management.

This statement, it should be noted, was consistent with the nature of most corporate combinations during the first three periods of corporate expansion discussed above. It inferred, however, the

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6 Ibid., p. 64.
existence of parent-subsidiary company relationships where the ideal conditions for the issuance of consolidated reports were lacking.

The attempts to design a generally accepted description of consolidation policy continued. Because of the complexity of the problem, stemming from an apparently unlimited variety of corporate affiliations, the standards developed tended to be negative rather than positive in nature. The emphasis was on prescribing conditions where the inclusion of a subsidiary would not be appropriate.

The most often mentioned and therefore most important of the conditions, the existence of one or more of which would make the inclusion of a given affiliated company in consolidated statements inappropriate, were the following:

1. There was an absence of a controlling interest in the affiliate. The SEC required the ownership of more than 50 per cent of the voting stock of the affiliate.\(^7\)

2. Control was being exercised only temporarily.

3. Control was legally restricted, as in the case of a subsidiary in bankruptcy, or where the court had enjoined the exercise of control.

4. Control was practicable but was not being exercised.

5. The interest in the affiliate was about to be disposed of or reduced.

6. A large, outside interest in the affiliated company existed.

7. The financial statements of the affiliate were as of a date or for a period different from that of the controlling company.

8. The affiliate was located in a foreign country where unstable political conditions, currency and trade restrictions, or any other unfavorable circumstances might exist.

\(^7\)Rappaport, op. cit., p. 266.
9. The affiliate conducted operations which were unlike or unrelated to those of the controlling company.

The negative nature of these conditions is readily apparent. Only indirectly do they refer to the circumstances in which consolidation would be essential to the most representative portrayal of the financial position and results of operations of the affiliated companies.

In its 1954 statement on the subject of consolidated reports, the American Accounting Association committee cited a series of examples of cases in which it might be desirable to exclude a subsidiary from consolidation. The examples included most of the points enumerated above. The Committee indicated, however, that if a majority-owned affiliate were omitted from the consolidated statements, reasons should be given for its exclusion. Further, where the affiliate was significant in size, appropriate disclosure should be made of (1) the affiliate's profit or loss and dividends declared for the current period and (2) the affiliate's undistributed earnings since it was acquired by the reporting company. In addition, the Committee indicated that the consolidation policy followed by the company should be disclosed since "such disclosure is particularly important at the present time because of the diversity of rules and standards in current use." 9

The American Institute of Certified Public Accountants committee, in the Accounting Research Bulletin issued in 1959, also

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9 Ibid., p. 196.
dealt with the problems of consolidation policy. This group, too, cited most of the same reasons for exclusion of an affiliated company. The recommendations, as to disclosure of financial information concerning the unconsolidated affiliates and the consolidation policy followed, differed from those of the American Accounting Association in only one important respect. The Institute committee recommended the use of the equity method for valuation of the investments in unconsolidated subsidiary companies. This method would reflect the growth in value of the parent company equity in assets of the subsidiaries and would recognize currently as earnings of the parent company the excess of the amounts earned over the dividends paid by the subsidiaries. The Institute committee viewed this method as preferable to carrying the investments at cost, which method was recognized as the more commonly used. The suggestion of the equity method as the preferable method offered a compromise between the inadequacies of current consolidation policies and the information which would be furnished by fully consolidated financial statements.

The conditions which appear to be germane to whether or not to include a given affiliated company in the consolidated financial statements have consistently reappeared in the limited literature on consolidation policy. These conditions fall into three recognizable categories:

1. The degree of control, feasible and being exercised, of the policies and actions of the affiliated company.

10 Committee on Accounting Procedure, ARB No. 51, loc. cit., p. 42.
2. The geographic location of the affiliated company, as to whether governed by the laws of the United States or some foreign nation.

3. The nature of the activities in which the affiliated company engaged, whether or not homogeneous with those of the consolidated group.

The same conditions are also apparent in the application of the policy to consolidated statements for published corporate annual reports.

The interpretation of acceptable consolidation policy and its application by companies issuing published financial statements provides a considerable lack of consistency in practice. The next section of this chapter is devoted to an examination of the practices followed.

Consolidation Policy in Practice

In a survey of consolidation policy practiced in 1954, it was determined that 103 of the 329 companies included had controlled but unconsolidated subsidiaries. The major reasons given for the exclusion were (1) the location of the subsidiary in a foreign country, (2) the operations of the subsidiary were of a type materially different from that of the consolidated group, and (3) the existence of a material minority interest in the subsidiary company.

The 1959 edition of Accounting Trends and Techniques (covering 1958 annual reports) reveals that 229 companies, of the 325 surveyed companies which indicated ownership of one or more subsidiary

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companies, consolidated some of their subsidiaries but excluded others. In addition, twenty-nine companies prepared parent company statements only. The major reasons given for exclusion of subsidiaries from consolidation were (1) exclusion of all foreign subsidiaries or subsidiaries in certain geographic locations and (2) exclusion of companies whose operations were not homogeneous with the parent company or consolidated group.

The recommendations of the American Accounting Association and American Institute of Certified Public Accountants committees, that the consolidation policy used be stated or disclosed, are not consistently followed. As to the consolidation policy of the companies surveyed, the editorial comment was as follows:

In most instances, the basis of consolidation is indicated rather than stated; usually the basis of consolidation can be determined only by observing the nature of the unconsolidated subsidiaries or the fact that there is no investment in unconsolidated subsidiaries.13

Examination of the published financial statements of industrial firms reveals the extremes of variations in reporting practice. It also reveals the evolutionary nature of accounting development. A number of examples of current practice follow.

The annual report for the Container Corporation of America for the year 1959 contained the following statement:

For the first time your Company's financial results are presented on a consolidated basis for domestic and foreign operations. It seemed appropriate to do this as both foreign sales and profits have reached a point of significance.14

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13Ibid., p. 134.

This was presented as part of the opening paragraph in the letter to shareholders. The notes to financial statements contain the statement: "These financial statements consolidate all foreign companies owned for one year or more." For 1958 and prior years the investments in foreign subsidiaries had been carried at cost, with a note to financial statements stating the equity in assets and earnings of the subsidiaries.

The 1959 report of the Ford Motor Company indicated the adoption of a new reporting practice. One of the notes to financial statements stated:

Effective January 1, 1959, the Company changed its accounting practices to include in consolidated net income the equities of the Company in net income of unconsolidated subsidiaries and foreign branches, and to include in earnings retained for use in the business the aggregate amount of the equities of the Company in unremitted income of unconsolidated subsidiaries and foreign branches . . . Prior to this change, net income of unconsolidated subsidiaries and foreign branches was included in consolidated net income only to the extent that dividends and income remittances were received by the Company or by a consolidated subsidiary, and net assets of unconsolidated subsidiaries and foreign branches were included in the consolidated balance sheet only to the extent of the related investments therein, which are carried substantially at cost.

This company has not adopted complete consolidation of subsidiaries but has revised its reporting to provide the reader of its annual report with a better perspective as to the overall financial picture of the company.

15Ibid., p. 19.

The General Motors Corporation, in contrast to the Ford Motor Company, consolidates all subsidiaries engaged in manufacturing or wholesale marketing operations, whether domestic or foreign. The Corporation has included Canadian subsidiaries in its consolidated group since 1951, Australian since 1953, and all others since 1954. In regard to other subsidiaries, not consolidated because of the lack of homogeneity of operations, the company indicated in a note:

Investments in subsidiary companies not consolidated (except for two minor subsidiaries) are carried at cost adjusted to include the corporation's proportion of undistributed profits since acquisition.\(^\text{17}\)

The difference in treatment of foreign subsidiaries of this Corporation and the Ford Motor Company, the two largest companies in the automobile industry, is indicative of the inconsistencies to be found in consolidation policies.

Minnesota Mining and Manufacturing in 1958 and prior years presented consolidated statements for the parent company and "Domestic and Canadian Subsidiaries." In 1959 this Company presented comparative statements for 1959 and 1958 on the same basis. It added, however, a third column labeled "All Companies - 1959." A note to the statements called attention to the fact that "the financial statements for 1959 include the accounts of all foreign subsidiaries which, except for Canadian subsidiaries, were not included in prior years."\(^\text{18}\) The inference, of this treatment and the explanations in

\(^{17}\)General Motors Corporation, *Annual Report*, 1959, p. 36.

the remainder of the report, is that foreign subsidiaries will be consistently included in future years.

The above examples are intended to indicate the nature of the thinking of some very respected companies concerning their own consolidation policy. They are cited as examples of companies providing increased information in the statements which they prepared and published. The following examples are intended to indicate contrasting methods of presentation.

American Smelting and Refining Company in its "Consolidated Balance Sheet" at December 31, 1959, showed total assets of $443,814,962. Of this amount, "Investments" comprised $88,493,530, or just under 20%. A schedule of "Investments" accompanying the usual statements indicated that the stock of one subsidiary company, 53.9% owned, carried at a book value of $12,603,022 had, at December 31, 1959, a quoted market value of $112,753,100. Similar market values were indicated for only part of the companies in which investments were owned. These values could be totalled to $214,909,000 and were applicable to but $31,330,251 of the invested amount. A note to the statements stated that "the consolidated statements include the accounts of all subsidiaries 99% or more owned." No information is to be found in the report as to the equity of the Company in the assets or earnings of the affiliated companies. The letter of the independent auditors opined that the statements "present fairly the financial position . . . in conformity with generally accepted accounting principles . . . " Yet the reader of the report

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20 Ibid., p. 25.
has no information concerning the financial position or operations of
the affiliated companies.

The report for Deere & Company for the year ended October 31,
1959, indicated in its "Notes to the Financial Statements" that "All
wholly-owned United States and Canadian subsidiaries except John
Deere Credit Company are consolidated herein."\(^{21}\) In the same note
the following paragraph appeared:

The Company follows the conservative practice
of charging consolidated net income with the net loss
of any subsidiary not consolidated but does not in­
clude in consolidated net income any earnings of un­
consolidated subsidiaries until they are received as
dividends; no dividends were received from any unconsol­
dated subsidiary during 1959. Accordingly, losses
incurred by unconsolidated subsidiaries amounting to
approximately $1,800,000 in 1959 ($1,100,000 of which
arises from John Deere Credit Company using a cash
rather than accrual basis of accounting) have been
charged against consolidated income whereas the net
income of other unconsolidated subsidiaries of ap­
proximately $400,000 in 1959 has not been included
in consolidated income.\(^{22}\)

The effect of this treatment on earnings for the year was not
material, only $700,000 as compared to reported earnings of
$48,451,000. The significance lies in the reference to "the con­
servative practice" as well as the use, by the subsidiary, of the
cash basis rather than accrual accounting.

Materiality of the information contained in accounting re­
ports is often used as the determining factor in judging the propriety
of the statements. The question of how much is material has not been
finally determined but there would appear to be no question but that


\(^{22}\) Ibid., p. 20.
the next two examples are of companies which considerably understate their apparent financial position or results or both.

General Refractories Company in its report for the year ended December 31, 1959, showed total assets of $83,906,829. "Investments in and advances to wholly owned European and Canadian subsidiaries, at cost, less allowance (Note 1)" were valued at $8,509,358, slightly more than 10% of the total assets.23 The Note consisted of this information only:

Based upon unaudited financial statements as of December 31, 1959 and the most recent audited financial statements available, December 31, 1958, the company's equity in wholly owned foreign subsidiaries substantially exceeds the net investment therein, on the basis of official year-end rates of exchange.24

In the "Report of the President" under the caption "Foreign Subsidiaries," but not covered by the opinion of the independent auditors, appeared this information:

The results of the operations of the Company's foreign subsidiaries continue to be satisfactory. Based upon unaudited figures, the equity in profit and loss of foreign subsidiaries in excess of dividends received in 1959 amounted to $2,210,000.25

The Company's earnings after taxes, not including this $2,210,000, were reported as $4,517,849 for 1959 and $3,590,436 for 1958.26 The consolidation of the unconsolidated subsidiary companies would have increased by almost 50% the reported income for the year 1959. Similar information for 1958 was not available in either the 1958 or 1959 annual reports.

24 Ibid., p. 11.
25 Ibid., pp 3-4. 26 Ibid., p. 9.
In its 1959 report, The Hoover Company presented "Consolidated Balance Sheets" for "The Hoover Company and Consolidated Subsidiary." Under the category of "Investments And Other Assets" appeared the caption "Investments in capital stock of foreign subsidiaries at cost - Note A . . $4,817,021." This was close to 11% of the total assets of $45,508,544, shown by the balance sheet. The "Statement of Consolidated Income" for the year ended December 31, 1959, indicated "Income Before Providing for Taxes on Income" of $11,957,723, of which $1,365,547 was derived from "Dividends from foreign subsidiaries - Note A." Note A, referred to in the balance sheet and the income statement as indicated, consists of the following (the "Total" column added here for ease of reference):

Note A -- The following data is based on reports of Public Accountants with respect to consolidated financial statements of Hoover Limited (England) and combined statements of subsidiaries in the Western Hemisphere. The financial statements of these companies are not consolidated with those of The Hoover Company which include only investments in and dividends received from these companies.

<table>
<thead>
<tr>
<th>Companies</th>
<th>Excess of the equity of The Hoover Company in the underlying net assets over cost ($2,861,944) of its investment in capital shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hoover Limited (England)</td>
<td>$26,338,662</td>
</tr>
<tr>
<td>Western Hemisphere</td>
<td>$3,942,145</td>
</tr>
<tr>
<td>Total</td>
<td>$30,280,807</td>
</tr>
</tbody>
</table>


28 Ibid., p. 12.
Companies

Hoover Limited in the Western Hemisphere Total

<table>
<thead>
<tr>
<th>Equity of The Hoover Company in net income for the year 1959</th>
<th>$7,593,648</th>
<th>$692,507</th>
<th>$8,286,155</th>
</tr>
</thead>
</table>

Dividends received by The Hoover Company during the year 1959, less foreign taxes withheld |

| $1,267,013 | $98,534 | $1,365,547 |

Equities in net assets and earnings have been computed at the approximate rates of exchange at December 31, 1959, but realization of such equities may be limited by exchange regulations, and would also be subject to taxes on income not presently determinable.

The Hoover Company increased its investment in capital shares of an affiliated Swiss Company during the year 1959 to $1,808,800 and there was no change in the investment of $146,400 in the capital interest of a German affiliate. Dividends were received and the net result of operations was a profit which was not significant.

The completeness of the information exceeds that of the usual report using a similar policy. It should, because the materiality of the information not included in the consolidated statements is obvious. The $30,280,807 excess of equity over cost was an understatement of assets equal to approximately 66.5% of the total assets indicated by the balance sheet. The difference between The Hoover Company's equity in net income and the dividends paid by these subsidiaries was $6,920,608 or an understatement of income before taxes of about 57.9% of that indicated in the income statement. The percentage of stated net income would presumably be a greater understatement due to foreign tax credits.

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29 Ibid., p. 13.
The latter two examples of consolidation policy are of particular interest because of the proportionately large difference in the reported financial information which a different policy would reveal. They are not, however, large companies in terms of present-day corporate size. While the relative differences in reported financial position and results of operations of the next three examples are not so great, the absolute amounts are large. Each of the companies has in excess of one billion dollars in invested assets.

International Business Machines Corporation, as of December 31, 1959, reported total assets of $1,390,637,247, and net income before income taxes of $300,133,212. Included among the assets is the investment, $57,255,603, in the IBM World Trade Corporation. In the rather extensive discussion of the financial aspects of the company, referred to as "an integral part of the financial statements," this wholly owned subsidiary was described as conducting the Corporation's business outside the United States, its territories and possessions. The equity of the Corporation in this subsidiary at the end of 1959 was stated at $223,588,323. This amount was $166,332,720 more than the value at which the investment was recorded, and about 12% of the total assets as indicated by the balance sheet. The earnings of this subsidiary for 1959 exceeded dividends paid to the parent company by $30,002,103. If this amount had been included in the consolidated statements, net income before taxes would have been increased by approximately 10%. In addition, the unconsolidated accumulated earnings of the subsidiary were equal to approximately 80% of the retained earnings reflected on the Corporation's balance sheet.

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sheet at December 31, 1959. At the end of the preceding year, 1958, the unconsolidated accumulated earnings of the subsidiary were equal to approximately 136% of the Corporation's retained earnings apparently available for dividends. This is indeed a strange way to report the financial position and results of operations of one of the world's most successful industrial corporations.

The International Harvester Company, for the year ended October 31, 1959, and prior years, has published only unconsolidated financial statements. At the end of this most recent year the Company reported total assets of $1,145,280,587, of which $133,971,550 was invested in subsidiary companies. For the year the Company reported income before taxes, except for a deferred income tax adjustment, of $137,745,234. In the "Notes to Financial Statements" the Company indicated that the equity in net assets of the subsidiaries exceeded the investment therein by $186,512,986, or by about 16.3% of the total assets indicated by the Company's balance sheet. It further indicated that the earnings of the subsidiaries for the year exceeded dividends received by the Company by $10,589,756, or by approximately 7.7% of the income before taxes per the income statement. In the text of the report, but not covered by the opinion of the independent auditors, the Company presented figures to show the effects on equity capital and net income of combining the Company and its subsidiaries. Such combined figures increased the net income per share of common stock from $5.10 per share to $5.86, or by 14.9%. The stockholder must be somewhat puzzled about which set of figures to use, those upon which an opinion was expressed by the independent, expert,

32 Ibid., p. 10.
auditor, or those more attractive ones called to his attention by the management of the company.

The largest of the three big companies chosen as illustrations here is Sears, Roebuck and Company. On its balance sheet as of January 31, 1960, this company showed total assets of $2,148,666,292. Of this amount, $213,411,847, or slightly less than 10%, was composed of investments carried "substantially at cost." The company stated that its consolidated statements included "all wholly-owned domestic subsidiaries except Allstate Insurance Company and Sears Roebuck Acceptance Corporation. The foreign subsidiaries are not consolidated." The company reported consolidated income before taxes of $403,170,983, and net income of $198,670,983. In a note to the statements, the company indicated that the equity in net assets of the subsidiaries exceeded the investment therein by $205,544,328, or about 9.6%. The equity in undistributed earnings of the unconsolidated subsidiaries was reported at $30,834,859. Of this amount $26,146,621 was for Allstate Insurance Company and Sears Roebuck Acceptance Corporation, both wholly owned domestic subsidiaries, and apparently-domestic manufacturing subsidiaries and affiliates. The total unrecognized earnings were equal to approximately 7.6% of consolidated income before taxes. However, allowing for the 85% dividends-received credit for tax purposes, the earnings of the unconsolidated domestic companies would add $22,224,628 to consolidated net income, or 11.2% of the net income per the income statement. The

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34 Ibid., p. 11.
actual amount of net income which would be shown upon the income
statement of the Company, if it were to prepare a consolidated
statement, is impossible to determine from the information given.
This amount is variable, dependent upon the intentions of the company
in regard to the ultimate disposition of the accumulated earnings
of the subsidiary companies.

The consolidated financial statements of the Textron Inc.
company for the year ended January 2, 1960, provide an illustration
of the perplexing ways in which consolidation policy can be applied.
Originally engaged exclusively in the textile industry, this company
has in recent years pursued a concentrated diversification policy,
acquiring all or a controlling interest of five companies in 1959,
for example. On May 31, 1959, Textron Inc. transferred the net
assets of "M B Electronics Division" to a subsidiary company,
Textron Electronics, Inc., in exchange for all (2,000,000 shares)
of the then outstanding stock of Textron Electronics, Inc. The
parent company, Textron Inc., later sold 500,000 shares, or 25%, of
the Textron Electronics, Inc. stock to its own, Textron Inc., share-
holders. The subsidiary subsequently issued 40,000 shares of its
stock to acquire the net assets of Globe Electronics, with an addi-
tional 70,000 shares issuable over the next ten years, dependent
upon the future earnings of Globe Electronics division. The subsidiary
also later issued 100,000 shares to American Research and Development
Corporation for cash. On February 17, 1960, subsequent to the end
of the fiscal year covered by the report, but described in the report,

the parent company transferred the net assets of two additional operating divisions of the parent to the subsidiary for 750,000 shares of the subsidiary's stock. As of January 2, 1960, the subsidiary had issued or potentially would have to issue a total of 2,210,000 shares, of which the parent company owned 1,500,000 shares, or 67.9%. As of February 17, 1960, the subsidiary had issued or potentially would have to issue a total of 2,960,000 shares, of which the parent company owned 2,250,000 shares, or 76.0%. In a note to the consolidated financial statements, the Textron Inc. report stated that "because of the substantial minority interest in Textron Electronics, this company is not included in the consolidated financial statements . . ." Of the maximum potential minority interest, at January 2, 1960, of 710,000, or 32.1% of the committed shares, the parent company's own shareholders held or had owned 500,000 shares, or 22.6% out of the 32.1% minority interest. If the assumption were made that the shareholders of Textron Inc. would continue to hold the shares of Textron Electronics, Inc., which they were granted the right to buy, the "outside" interest in the potential outstanding shares of Textron Electronics, Inc. would have been, at most, 7.1%. This hardly could be construed as a "substantial minority interest." Even the total shares held or to be held by shareholders other than the parent company, as of February 17, 1960, 24% of the subsidiary's potentially outstanding shares, would still permit Textron Inc. to control its subsidiary company. The fact that the net assets of

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36 Ibid.
this subsidiary were formerly owned and included in its previous financial statements makes the failure to consolidate the subsidiary company appear completely ridiculous.

One last example of consolidation policy is appropriate here. In the preceding chapter, National Lead Company was cited as one of the first companies to prepare consolidated financial statements, for the year 1892. In its "Sixty Eighth Annual Report," for the year 1959, the Company presented the balance sheet for "National Lead Company and its Consolidated Subsidiaries." Under the caption of "Investments in, at cost or below, and advances to unconsolidated subsidiaries, less reserve of $3,406,163 (Note 4)" was the amount of $19,685,502, slightly more than 5% of the total assets of $380,511,351. Despite its length, Note 4 is quoted below in its entirety.

Unconsolidated subsidiaries comprise domestic subsidiaries more than 50, but less than 100 per cent owned, and foreign subsidiaries, other than wholly owned Canadian subsidiaries.

Based upon financial statements of the major unconsolidated subsidiaries (other than those in Continental Europe) as of the close of their respective fiscal years, the equity of the Company in the net tangible assets of those subsidiaries and amounts relating to such equity approximated the following:

<table>
<thead>
<tr>
<th></th>
<th>1959</th>
<th>1958</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity in net tangible assets</td>
<td>$25,740,000</td>
<td>$21,465,000</td>
</tr>
<tr>
<td>Excess of equity over the Company's net investments and advances</td>
<td>12,514,000</td>
<td>11,534,000</td>
</tr>
</tbody>
</table>

38 Ibid.
Increase, decrease* in
excess equity during
year $ 980,000 $ 4,264,000*

The equity in net tangible assets, shown in
the preceding paragraph, includes $7,445,000 for 1959
and $7,271,000 for 1958, represented by foreign net
tangible assets, translated into U. S. dollars at
appropriate rates of exchange.

The Company's net investments in and advances
to Continental European subsidiaries were $6,227,204
and $6,268,439 at December 31, 1959 and 1958, respec­tively. Unaudited financial statements as of September
30, 1959 and 1958 received from the Continental Euro­
pean subsidiaries indicate that the Company's equity
in the net assets thereof approximated the following
foreign currency amounts:

<table>
<thead>
<tr>
<th>Currency</th>
<th>1959</th>
<th>1958</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norwegian kroner</td>
<td>34,549,000</td>
<td>33,145,000</td>
</tr>
<tr>
<td>Belgian francs</td>
<td>122,488,000</td>
<td>119,095,000</td>
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<tr>
<td>Dutch florins</td>
<td>4,130,000</td>
<td>3,751,000</td>
</tr>
<tr>
<td>French francs (old)</td>
<td>84,345,000</td>
<td>75,871,000</td>
</tr>
<tr>
<td>German deutsch marks</td>
<td>65,637,000</td>
<td>59,876,000</td>
</tr>
</tbody>
</table>

The realization of certain foreign assets and
earnings is subject to various exchange and other re­
strictions imposed by the respective foreign govern­
ments. See Note 7 with respect to dividends received. 39

The Company presented a considerable amount of factual information
concerning its unconsolidated subsidiary companies. But the informa­
tion was of little use. The statements for the Continental European
subsidiaries were unaudited even though for fiscal years ended three
months before the end of the fiscal year of the parent company. The
values stated for the Company's equity in net assets of those com­
panies were in foreign currencies. The reader of this Note, even if

39 Ibid., p. 28.
he knew the exchange rate for each currency at the end of September, 1959, could not have made the conversion because not all assets should be converted at the year-end rate. And the conversion should not have been left to the reader of the report if statements are to be useful to an average investor. The Company's equity in net assets in excess of the investment in all unconsolidated subsidiaries was stated elsewhere in the report as "approximately $30,200,000." Using the quoted exchange rate as of 4:00 p.m. on September 30, 1959, for the Continental European currencies and the "Equity in net tangible assets . . . $25,740,000" indicated in the Note, the total value could be computed at $49,776,551, or $30,091,049 in excess of the value at which these investments were carried in the balance sheet. Therefore, the exchange rates used were approximately the current rates for all the assets.

The examples cited above were selected as being indicative of the practices currently followed by some American industrial firms. They are not, by any means, all of the examples which are to be found in the latest published annual reports. The purpose here is to point out what is currently practical consolidation policy. This is not intended to be construed as an exhaustive, statistical survey of corporate annual reports.

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40 Ibid., p. 15.

41 Wall Street Journal, October 1, 1959, p. 22.
The Lack of Consistency in Theory and Practice

Probably the most important obligation of the accountant is to present the financial information of a company in the clearest possible way. The only insight most investors and creditors have into the operations and status of a given company is through the company's financial statements. The independent certified public accountant who expresses an opinion on the fairness of the financial statements has a responsibility to all who use those statements. That responsibility is to insure the user that the statements prepared by the management of the company are a reasonable representation of the financial position and results of operations of the company.

The professional accounting associations have concentrated their efforts, particularly during the past twenty-five years, on developing and urging the adoption of generally accepted standards, principles and procedures for reporting purposes. The Securities and Exchange Commission was legislated into existence to enforce the laws requiring the availability of adequate financial reports for companies desiring to list securities on the organized securities exchanges. The accounting profession, with some patient guidance from the Securities and Exchange Commission, has made a great improvement in financial reporting for both the reports required to be filed with the Commission and published annual reports over which the Commission has no direct control. The improvement has been in form and content of the reports as well as the techniques of accumulating and evaluating the information from which the reports are prepared.
It is, undoubtedly, too much to hope that there will ever be complete agreement on every facet of proper financial reporting. This would be true because of the infinite number of variations in financial patterns and relationships if economic conditions remained static. It is even more true because of the dynamic nature of business, which is off on another mode of operation before the facts of the last can be recognized and assimilated in the financial statements. A professional group, usually large and composed of members with many diverse points of view, does not ordinarily change its time-honored procedures either quickly or unanimously.

The usual reference in accounting parlance to "generally accepted accounting standards" is apparently inappropriate in regard to consolidated financial statements as a reporting form. If the wide variation in practical application can be construed as indicative, the accounting standards for determining consolidation policy are more general than accepted. This fault can be attributed to (1) the negative nature of the standards applicable to inclusion of a subsidiary in the consolidated group and (2) the failure of the standards to fit the present circumstances which have changed since the standards began to crystalize. An appraisal needs to be made of the applicability of these standards in terms of the corporate relationships and activities of the present period.

Summary

There is a body of theory concerned with the appropriateness of inclusion of a given affiliated company in consolidated financial
statements. Whether such an affiliated company is included or excluded is dependent upon the consolidation policy of the parent company. The theory has been developed throughout a period when the nature of corporate expansion was in the process of evolution. The theory may be inappropriate to the present forms of corporate relationships and changed nature of corporate ventures.

There is an apparent lack of consistency from company to company in the presentation of financial information for a corporation and its affiliated companies. This lack of consistency may be due to a lack of general understanding as to the circumstances in which inclusion of a given affiliated company is proper. If this is true, the proffered standards of consolidation policy need to be examined as to their validity and to the circumstances in which consolidation is not only appropriate but essential to a clear presentation of financial information. These standards are generally concerned with (1) the homogeneity of the group of consolidated companies, (2) the geographic location of the various companies of the consolidated group, and (3) the amount of control, direct or indirect, of the parent company over each of the other companies in the consolidated group. The standards are examined individually in the following chapters.
CHAPTER IV

HOMOGENEITY AS A STANDARD

One of the conditions which have been proposed as governing the appropriateness of consolidated financial statements is that the companies included should be integral parts of a common enterprise. It would require that each company should contribute its own essential and characteristic portion of the primary production or marketing activity of the overall business. In other words, the several members of the group of separate legal entities composing the consolidated economic entity should be homogeneous in nature or purpose. This chapter is devoted to an examination of this requisite as a standard for consolidated financial statements.

The Theoretical Aptness

As was indicated in the preceding chapter, concern with the development of standards to be incorporated in a theory of consolidation policy became apparent in the 1930's. This was after the end of three recognizable periods of corporate expansion and before the beginning of the present one. The ideas developed were based upon the practical examples observed and to be dealt with. To this time, the instances of ownership by a parent company of the stock of a subsidiary engaged in an unrelated activity were relatively few. The usual corporate combinations were of companies whose pursuits
were practically identical with, or furnished a source of supply or a
market for products or services for, the related companies. It is not
surprising, therefore, to find that the early writers on the subject
were concerned with the appropriateness of inclusion, in the consoli-
dated statements of the parent company, a subsidiary acquired from
outside its own area of operations.

The 1934 edition of Montgomery's Auditing contained this state-
ment on the subject of homogeneity:

Oftentimes the type of business done by a
particular subsidiary so differs from that conducted
by the group as a whole that consolidation of its
figures with those of the other companies would only
lead to confusion or unnecessary complexity in the
statements. Under these circumstances a fairer pre-

tation results from showing in the consolidated
balance sheet merely the investment in the subsidiary
supplemented by its financial statements unconsoli-
dated.¹

This book, a standard reference work in accounting, was first published
in 1912 but no mention was made of the above point in prior editions.

In addition to the statement concerning "homogeneous" subsid-
iaries cited in the previous chapter, Kohler, in the study conducted
for the American Accounting Association in 1937, indicated that "in-
cluded in the consolidated group should be all subsidiaries . . .
excepting only, where material, a subsidiary whose operations are
unrelated to those of its controlling company and any other subsid-
iary."²

¹Robert H. Montgomery, Montgomery's Auditing (5th ed.; New

²Eric L. Kohler, "Some Tentative Propositions Underlying Con-
solidated Reports," The Accounting Review, XIII (March, 1938), 64.
The statements by these two respected members of the profession no doubt reflected the thinking at the time. However, it should be noted that neither the statement nor the context in which each was made was definitive as to what actually constituted differing or unrelated operations. Each was restrictive rather than provisionary.

Other authors have expressed similar views and, like Montgomery and Kohler, have greatly influenced the development of theoretical consolidation policy. W. A. Paton wrote:

"... A composite picture of the affairs of a group of companies which are closely integrated or allied from an operating standpoint obviously has more significance than a joint report for a heterogeneous collection of companies. In fact where the concerns are highly dissimilar the preparation of consolidated statements may be unwise even if the affiliation is complete as far as ownership and control are concerned."

It is not surprising, therefore, to find the term "heterogeneous" referred to in the latest pronouncement by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants.4

Maurice Moonitz discussed "similarity of operations" as a requisite to consolidated statements, also.5 Much of his discussion dealt with the propriety of consolidation of a banking subsidiary with an industrial enterprise. His position was that such a subsidiary should not be consolidated because "to combine accounts of financial and non-financial concerns leads to an unwieldy fusing of

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4 Committee on Accounting Procedure, ARB No. 51, loc. cit., p. 42.
5 Moonitz, op. cit., pp. 32-35.
"data defying fruitful analysis" and "public policy would prohibit the
merging of a manufacturing company and a bank into a single corpora-
tion . . . " The reference to "financial concerns" is interesting
in view of the fact that two paragraphs further on he indicated that
inclusion of an installment finance company in the consolidated
statements would be proper if "an integrated area of operations
exists and, despite the dissimilarity of functions performed." General use of the term "financial concern" would include both banking
and finance companies. Also, the reference to "merging of a manu-
factoring company and a bank" reflected the underlying philosophy
that consolidated statements portray what may eventually be one
single, legal, corporate entity. Moonitz concluded "investments in
nonintegrated controlled companies then assume a status in consoli-
dation analogous to that accorded nonoperating assets in a single-
company balance sheet." The Committee on Concepts and Standards of the American
Accounting Association in 1954 restated the desirability of in-
cluding, in the consolidated statements, companies forming an integral
part of an overall business operation. But a thread of doubt was
revealed by the wording of this group's recommendations:

. . . In some instances, the activities of an enter-
prise may be so extensively integrated that a sub-
sidiary is performing a function, such as a finance
or insurance function, which extends beyond the
ordinary productive and distributive processes. A
subsidiary of this type may be excluded from con-
solidation in order to avoid the commingling of
dissimilar assets and sources of income. In view,
however, of the marked trend toward diversification
of activities on the part of American businesses,
care should be exercised in the use of the "primary activity" of the enterprise as a criterion of inclusion or exclusion. (Italics mine)\(^9\)

The use of the word "may" was indicative apparently of a change in thinking from that of earlier writers. And formal recognition was given to the change in purpose of business expansion; diversification was recognized as an alternative to horizontal or vertical integration.

The Committee on Accounting Procedure of the American Institute of Certified Public Accountants considered the homogeneity requisite in 1959. The recommendations of this group were as follows:

... 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. (Italics mine)\(^10\)

The indecision of the Committee was indicated by the wording of its statement in the use of the words "may" and "preferable" and the recognition of alternative presentations. The result is a negative position, leaving to the individual members of the profession the


\(^10\) Committee on Accounting Procedure, ARB No. 51, loc. cit., p. 42.
latitude to include or exclude a heterogeneous subsidiary. The practical problem was recognized but no solution was rendered.

The Securities and Exchange Commission has contended with the problem of whether or not to consolidate a non-homogeneous subsidiary company. As mentioned previously, this body has left to the accounting profession the responsibility for determining "generally accepted" principles and procedures for financial presentations. But where the profession has not taken a positive enough stand the Commission has "suggested" acceptable presentation techniques in individual cases. Rappaport says:

SEC will probably not insist on consolidating a subsidiary which is in a business totally different from that of the parent and the parent's other subsidiaries. Even this statement may have to be hedged, however, in view of the increasing tendency among American businesses to diversify their operations. (Italics mine)\(^{11}\)

and

SEC will probably not insist on consolidating a finance subsidiary with a manufacturing company. (Italics mine)\(^{12}\)

The Chief Accountant of the Commission indicated that it is often necessary to use "friendly persuasion" to convince a registrant to include a non-homogeneous subsidiary in the consolidated statements.\(^{13}\)

This was in reference to a real estate holding subsidiary of a chain of retail stores, as an example. No opinion was expressed as to the propriety of including an insurance or finance subsidiary of a

\(^{11}\) Rappaport, op. cit., p. 268.  
\(^{12}\) Ibid.  
\(^{13}\) Interview with Andrew J. Barr, Chief Accountant, Securities and Exchange Commission, Washington, D. C., March 29, 1960.
manufacturing concern. However, Rule 4.09 (b) of Regulation S-X provides that,

(b) The statements of an insurance company other than a life insurance company may be consolidated if all of the following conditions exist:
(1) The insurance company is a totally-held subsidiary of the top parent included in the consolidation;
(2) Such top parent is not an insurance company, investment company, or bank holding company;
(3) The insurance company engages in no business of a material amount other than the insuring of risks arising in the ordinary course of business of such top parent and its other subsidiaries; and
(4) Separate financial statements for the insurance company are filed.¹⁴

This is, of course, a permissive provision rather than obligatory. But it would appear unlikely that, in view of the nature of insurance accounting, the Commission would object to the inclusion of a finance subsidiary as well. The SEC apparently does not consider the lack of homogeneity of a given subsidiary to be a condition which would justify its exclusion from the consolidated financial statements.

The Practical Incongruity

The nature and direction of corporate expansion, since the end of World War II, have been noticeably different from the pattern developed prior to that time. There has been and is a concerted effort on the part of corporate managements to expand and diversify the search for profitable operations. The growth of the domestic economy and certain provisions of the income tax laws have contributed to the change in pattern. The rapid increase in population and rise in per

capita income have created new markets for consumer goods and investments. Insurance companies and installment finance companies have grown and multiplied to an extent without parallel in the past.

The growth in size of corporate enterprises has been accompanied by a change in management methods. The individual firm, in many cases, has become so large as to prohibit efficient centralized management. As a result there has been a delegation of responsibility and authority to divisional managers which, except for broad general policies, permits such divisions to operate almost as autonomously as though they were separate companies. Interdivisional transactions are carried on as they would be between unrelated business firms. And profitability is the major criterion by which each is judged.

The economic necessity for such decentralized management has removed the advantage of similar or integrated operations as a prime cause for combining separate legal entities to achieve economies of management because of larger size. Decentralized management of the individual units, whether divisions or subsidiaries, can be tailored to meet the specialized requirement each unit might have. And, having adopted this philosophy, there is little left to prevent the investment of corporate capital in any venture which offers the most attractive profit potential.

The remarkable success of some companies in a given industry in contrast to other companies in the same industry has presented policy problems for management. Public opinion and governmental action might be adverse if the success and growth of some companies led to the failure and disappearance of competing companies. There has been an apparent reluctance on the part of some industrial firms
to acquire a much larger share of a given market than they already held. The assets accumulated as a result of successful operations, therefore, have been channeled into alternative areas of investment, further compounding the diversity of the companies’ operations.

Technological changes have contributed greatly to the diverse ventures which may be simultaneously pursued by a single economic enterprise. Such changes may include the virtual obsolescence of a product, which was formerly a primary source of revenue, as well as improved methods of production which have reduced the number of firms which could economically compete. Aircraft companies which achieved large size during World War II have been faced with a greatly reduced demand for their products and have had to seek new products or go out of business. Textile manufacturers, having improved production techniques and machinery, have found themselves with an oversupplied market for their products and have shifted their corporate capital into other lines of endeavor. Textron Inc., cited in the preceding chapter, indicated participation in a variety of product lines in its 1959 annual report.\textsuperscript{15} Exclusively a textile manufacturer until 1952, this company obtained but 21% of its revenues from textiles in 1959. This is but one of a countless number of companies which have undergone similar transitions.

Vertical integration of business operations has been an ever-increasing feature of industrial growth since the development of mass-production techniques. By the end of the 1930's the largest industrial firms, such as automobile manufacturing companies, were

\textsuperscript{15} Textron Inc., Annual Report, 1959, p. 15.
integrated to the extent of being able to perform almost all of the productive functions from the extraction of the required natural resources to the assembly of the finished article. In many instances the finished product was channeled to the ultimate consumer through agencies owned or controlled by the manufacturing company. Since the end of World War II consumer credit has been greatly expanded and consumer financing has grown into a large and lucrative business. The manufacturing companies, observing the profitableness of financing consumer purchases, have logically moved into this field. It has been a natural move for such companies to make, being but one more step in the integration process. Further, to remove some of the risk attached to such financing, the companies have insisted that insurance should be carried by the borrower on the product pledged as collateral. Such insurance coverage was required at the time the loan was made and the financing agency found it profitable to sell that insurance. So, it is now not at all unusual to find companies, originally in the business of fabrication alone perhaps, fully integrated. A single corporate enterprise, through its own operating divisions and/or subsidiaries, produces its own basic materials, processes them, forms the materials into parts, assembles the parts into a completed product, sells the product through its own marketing agencies, finances the greater portion of the sales price, and sells insurance to the customer to protect the seller from loss. The financing and insuring functions are a part of the overall profit-seeking plan and represent what appears to be the final step in the complete integration of a business firm.
Conflict of Theory and Practicality

Economic conditions and the direction of business activity are constantly changing. The trend of each is difficult to ascertain at times. Ideas, on the other hand, are slow to change. Often before knowledge is sufficient to permit the development of a well thought-out solution to a problem, the problem no longer exists or has been drastically altered. This appears to be the case of the concept of homogeneity as a standard of consolidation policy.

The standards of consolidation policy were first proposed when the nature of business activity and the direction of business enterprise were different from that of today. The scope of activities into which a single business enterprise may venture has evolved but the standards of consolidation policy have not kept pace. The requisite that only subsidiary companies which were "similar in activity" should be included in the consolidated statements is an apt example. The idea of homogeneity of operations does not fit the present, practical circumstances of diversified business operations.

Homogeneity as a condition or standard for consolidation should be discarded. In view of the diversity of operations to be found in countless modern business enterprises lack of similarity of operations is no longer a valid reason for exclusion of a subsidiary from the consolidated statements.

The financial statements should provide to the reader of them a complete portrayal of the assets over which the enterprise has control. However diverse in nature those assets might be, they each have some part in the overall activities of the enterprise. Further, the
financial statements should reveal all of the existing obligations which must eventually be satisfied by the disbursement of the firm's assets. Failure to consolidate a subsidiary company results in offsetting excluded liabilities against excluded assets. This is in direct opposition to a basic accounting tenet that such offsetting is unacceptable for reporting purposes. Finally, the financial statements should portray the entire revenues which the assets of the firm produce and the expenses incurred to produce those revenues. The reader of the statements is entitled to have insight into the financial condition and results of the entire economic enterprise involved, not just that part which happens to be homogeneous.

Repudiation of the homogeneity requisite will be reluctantly, if ever completely, acceded to by the profession of accounting. The concept has been too long a part of accepted theory, and old ideas, again, are difficult to replace. In recognition of the probable reluctance of many theorists to subscribe to combining the statements of, for example, a commercial bank with those of a group of industrial companies, an alternative to complete consolidation is proposed. The investment in those subsidiaries excluded from consolidation should be accounted for by the "equity" method. That is, the asset account reflecting, in the otherwise consolidated balance sheet, the investments in excluded subsidiaries should reflect underlying asset value, not original cost or any other value. This would result, also, in reflecting in the income statement the income or loss of the subsidiary for the current year and the accumulated earnings or losses since the subsidiary company became a part of the economic entity. The amount of information furnished to the reader of the statements
would not be as complete as that provided by full consolidation. It would, however, be far more complete than that furnished by companies giving very little or no information concerning excluded subsidiaries and presenting what is given in the form of footnotes or supplementary schedules.

This alternative proposal was, as indicated in the preceding chapter, also offered as an alternative in Accounting Research Bulletin No. 51. It was an alternative to a less strong position, however, than the one offered here—that homogeneity be discarded as a standard.

One member of the Committee agreed to issuance of the Bulletin with this qualification:

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 . . . 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 . . . is generally preferable, supplemented by such summarizing financial information, in footnotes or otherwise, as may be appropriate.

This qualification of opinion did not make specific reference to the lack of homogeneity as a basis for exclusion from the consolidated statements. But the reference to "full consolidation" as "generally preferable" appears to remove similarity of operations as a requisite.

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17 Ibid., p. 50.
The profession of accounting has the responsibility of presenting financial information to others in clear, useful form. There should be a consistency of presentation between companies as well as between accounting periods. The present diversity of practice, in the treatment of subsidiaries whose operations are considered dissimilar in nature, is irresponsible. The profession should adopt a positive approach to the problem, recognize that diversification of operations is normal, and insist that generally subsidiaries should be included in the consolidated statements. If the profession admits to certain exceptions to this treatment, such exceptions should be definitively established.
CHAPTER V

GEOGRAPHIC LOCATION AS A STANDARD

The search for a unified, generally accepted body of theory of accounting dates from about the beginning of the 20th century. The most intense concentration of effort, however, and the greatest advancement have been since the 1930's. Due to adverse business and financial conditions and uncertainty as to the future, conservatism became the most important consideration in financial reporting. In connection with no aspect of accounting is conservative treatment more readily apparent than with business operations conducted in foreign countries. The appropriateness of including foreign subsidiary companies in consolidated financial statements is examined in this chapter.

Historical Background to the Development of This Standard

The investment of capital to any appreciable extent by United States business firms in foreign operations has been a fairly recent development. It represents a reversal of direction for the flow of capital because the early economic growth of this country was financed by capital from foreign sources.

Economic conditions, for the establishment and expansion of domestic business units, were favorable from the beginning. Land and other natural resources were abundant, apparently unlimited in quantity.
Immigration of people from most parts of the world was encouraged and the resulting rise in population provided an increasing market for products. As the population increased, the western frontier was gradually pushed ahead. The westward movement of population and business firms is still discernible. Because of the opportunities for expansion in the domestic market, there was no good reason for investing already scarce capital in risky foreign ventures. The nation was, for the most part, self-sufficient.

As the economy expanded and developed, new means of transportation and communication were devised. Improved production techniques led to the invention and mass production of new products. The standard of living of the people improved and there was a demand for products which could most economically be procured from foreign sources because, perhaps, of climatic conditions, wage differentials, or limited existence of a natural resource. United States capital was channeled into foreign areas to take profitable advantage of the demand for such products.

The areas were limited in which United States capital was welcome. European countries were, in great part, industrialized and did not welcome foreign capital. Such countries were apt to be exporters rather than importers of capital. In addition most had pursued a policy of colonialism and the greater part of the world was closed to business ventures of any but nationals of the country involved. Opportunities for foreign investment by United States firms were few and were limited, for the most part, to the extractive industries. Such investments as were made were in economically backward and undeveloped areas of the Middle East and the Western
Hemisphere. In most instances a notable feature of these areas was political and social instability. Investment was risky, so that the profit potential needed to be high to compensate for the risk involved.

Those were the circumstances in which the development of the use of consolidated financial statements was begun. Ownership by a domestic company of a subsidiary corporation with foreign operations was unusual. Ownership by a domestic company of a subsidiary which was chartered by and under the jurisdictional control of a foreign nation was extremely rare. The resources of an economic enterprise which were invested in such foreign areas were a relatively small proportion of the enterprise's total resources. Therefore, the propriety of inclusion of such subsidiaries in consolidated statements received little or no attention.

Up to World War I, the United States was a debtor nation in the area of foreign investment. To that time, interest and dividends paid to foreigners exceeded the new investments each year by United States investors in foreign countries. Economic conditions following the war caused that to change, however, and foreign investments increased through the 1920's and were maintained into the 1930's. The method of investment by business firms in foreign operations consisted principally of the establishment of foreign branches or divisions but also included the acquisition or organization of foreign subsidiary companies.

Political conditions became strained in many parts of the world during the 1930's. Concern with the effect of political unrest and the threats of war caused the accounting profession to consider
carefully the accounting for foreign operations. This was done as part of the concerted effort to develop standardized accounting techniques generally. And, because of domestic and foreign economic conditions and unfavorable foreign political conditions, the approach to accounting for foreign operations was a very conservative one.

Kohler, in 1937, indicated that there should be excluded from the consolidated statements "a foreign subsidiary, especially where the rate of exchange fluctuates widely, restrictions exist on the withdrawal of funds, unfavorable legislation is in force, or the foreign government is in the process of change."1 This statement, if broadly interpreted, would provide for the exclusion of practically every subsidiary located in a foreign country under the conditions in the world at the present time.

The serious nature of foreign political and economic conditions in 1939 prompted the executive committee of the American Institute of Accountants to request, on October 31, 1939, that the Committee on Accounting Procedure consider the question of foreign operations. Accordingly, this Committee issued a special bulletin in December of 1939, a mere two months later. The bulletin discussed the risk involved in regard to the assets invested abroad and indicated that "it is clear that in many cases in which statements of foreign subsidiaries have been consolidated with statements of United States companies this practice can no longer be followed."2 The

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2 Committee on Accounting Procedure, ARB No. 4 (Special), loc. cit., p. 29.
ultimate in conservative practice was recommended with this statement:

As to earnings, a safe rule for United States companies to follow would be that in their own accounts earnings from foreign operations for the current year should be shown only to the extent that actual remittances for them have been received in the United States. Provision should be made also for known losses of subsidiaries. In other words, the position shown should not be made better by the omission of foreign results.

The statement apparently could have been construed to mean that only the dividends received from foreign subsidiaries should appear in the consolidated statements even though the subsidiaries reported earnings in excess of dividend distributions for the year.

In regard to consolidation of subsidiary companies, the Committee offered a wide range of possible treatments:

The following procedures are among the possible ways of providing adequate disclosure of information relating to foreign subsidiaries:

(a) To exclude foreign subsidiaries from consolidation and to furnish: (1) statements in which only domestic subsidiaries would be consolidated; and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein. The aggregate amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated. If these investments include any amount of surplus of foreign subsidiaries and such surplus had previously been included in consolidated surplus, the amount should be separately shown or earmarked in stating the consolidated surplus in the statements here suggested. The exclusion of foreign

\[\text{Ibid.}, \ p. \ 29.\]
subsidiaries from consolidation does not make it permissible to include intercompany profits which would be eliminated if such subsidiaries were consolidated.

(b) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition the summary described in (a) (2) above.

(c) To furnish: (1) complete consolidated statements, and also (2) consolidated statements for domestic companies only.

(d) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition parent company statements showing investment in and income from foreign subsidiaries separate from those of domestic subsidiaries.4

This variety of alternative, acceptable procedures provided for a complete lack of consistency of treatment, as between companies, of investments in foreign subsidiaries. A later Committee on Accounting Procedure in 1953 reaffirmed this position. The wording of the above procedures remained practically unchanged but the following introductory statement was inserted:

In view of the uncertain values and availability of the assets and net income of foreign subsidiaries subject to controls and exchange restrictions and the consequent unrealistic statements of income that may result from the translation of many foreign currencies into dollars, careful consideration should be given to the fundamental question of whether it is proper to consolidate the statements of foreign subsidiaries with the statements of United States companies. Whether consolidation of foreign operations is decided upon or not, adequate disclosure of foreign operations should be made.5

The statement cast doubt upon the advisability of presenting consolidated statements in which foreign subsidiaries were included. As had


been true of earlier recommendations, the statement was negative in nature and added little to the solution of the problem of developing a generally accepted policy in regard to consolidated statements. Yet, by that time, 1953, it had become obvious that there was rapidly expanding investment by United States companies in foreign operations through the subsidiary company device.

The Committee on Concepts and Standards of the American Accounting Association did nothing to clarify the situation in its 1954 statement. This Committee's only reference to foreign subsidiaries consisted of the following:

With disturbed conditions in foreign countries, which may take the form of exchange restrictions or unstable political or economic conditions, it may be desirable to omit some or all foreign subsidiaries from consolidation. In any case, appropriate disclosure of the results of foreign operations and of their status in the consolidated statements should be made. (Italics mine)^6

This statement may well be the basis for corporations using what appears to be a purely arbitrary selection process to include some foreign subsidiaries in the consolidated statements while excluding others. The wording of the statement certainly did not provide any basis for consistency in accounting practices.

The Securities and Exchange Commission has adopted a somewhat more positive attitude in regard to foreign subsidiaries. Rule 4.02 of Regulation S-X provides:

Due consideration shall be given to the propriety of consolidating with domestic corporations foreign

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subsidiaries whose operations are affected in terms of restricted foreign currencies. If consolidated, disclosure should be made as to the effect, insofar as this can be reasonably determined, of foreign exchange restrictions upon the consolidated financial position and operating results of the registrant and its subsidiaries.\(^7\)

Rappaport indicates that "if such foreign operations are essentially an arm or extension of domestic operations, and are actively being conducted, the SEC's view is that there is a presumption in favor of the consolidation thereof, despite the probable impact upon the foreign operations of unfavorable political and economic factors."\(^8\)

Almost every attempt to deal with the appropriateness of including, in consolidated financial statements, a subsidiary geographically outside the legal jurisdiction of the United States has achieved the same result. The provisions concerning such foreign subsidiaries have been restrictive ones. The lack of a positive set of principles has provided the basis for a lack of consistency on the part of companies preparing published annual reports. An examination of current reporting practices reveals the disparity of treatment which has existed.

A survey of reporting practices for the year 1958 revealed that, of 525 companies with subsidiaries, 88 companies excluded one or more foreign subsidiaries from the consolidated statements.\(^9\) Of those 88 companies, 36 excluded all foreign subsidiaries and 52 excluded some based upon geographic location but included others.

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\(^7\)Rappaport, *op. cit.*, p. 266.


In contrast, 153 of the 525 companies consolidated all wholly-owned and active foreign subsidiaries. The selected illustrative cases commented upon in Chapter III reveal the material differences in reported financial position and results of operations which may arise from such variations in practice.

**Earlier Proposals of Questionable Suitability in Present Circumstances**

The relative importance of foreign investments to domestic corporations has changed drastically in the twenty-five or so years since standards for consolidated statements began to receive much attention. In the 1930's a minority of United States companies had investments in areas outside the United States, its territories and possessions. Much of such foreign investment which did exist consisted of foreign branches or divisions. In the 1960's it is the companies without foreign operations which are in the minority. And there is a marked trend toward the use of the subsidiary company device as the vehicle for the pursuit of foreign operations. The 1959 edition of *Accounting Trends and Techniques* indicated that 355, or 59%, of the 600 companies surveyed for 1958 revealed the existence of foreign subsidiaries. 10 As late as 1948, the same type of survey had determined that 165 of 525 companies, or 31%, reported the ownership of foreign subsidiaries. 11 While the companies included were not identical in those two surveys, the trend toward foreign investment is,

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10 Ibid.
nevertheless, indicated. Further, examination of corporate annual reports selected at random for 1959 reveals countless indications of new foreign operations established during that year. And securities brokerage firms will, upon request, furnish long lists of companies which have either just expanded or plan to establish foreign operations.

The underlying reasons for the increased foreign investment are many and varied. They are, almost without exception, the result of developments which were an outgrowth of World War II or which have become apparent since that time. Corporate management has felt free to take advantage of foreign investment opportunities because of a major change in the attitude toward foreign countries of the public, including the corporation's own shareholders. That opinion, while perhaps not completely "one world" in attitude, is certainly a reversal of the isolationism prevalent prior to the war.

The wave of nationalism which has resulted in political and economic independence for many former territories and possessions of European countries has opened new investment opportunities. Industrialization is being attempted by nations which formerly had an agricultural or an undeveloped economic society. The United States government has pursued a policy of financial assistance to underdeveloped and war-disrupted economic systems. The result has been an increase in the standard of living in many areas of the world and an increased market for manufactured products.

Many if not most foreign governments have welcomed the investment of United States capital and production technology. The employment of the people of the country has not only provided
increased amounts of dollar credits to permit purchases of manufactured products but also provided needed training in productive skills and techniques for the natives. The foreign governments have instituted certain controls over business activities for outside investors but the controls have been designed primarily to prevent exploitation. As such they have not served as deterrents to continued investment by domestic companies. Corporations have considered the profit opportunities so attractive that they have even invested in affiliated foreign companies where as much as 50% or more of the affiliate's stock is owned by nationals or the government of the foreign country.

Companies have found foreign investments profitable for a number of reasons, chief among which are listed: (1) The underdeveloped economic areas provide an expanded market for manufactured products where the domestic market cannot or will not absorb all the product which facilities are capable of producing; (2) entrepreneurial advantage can be gained by exploiting the foreign demands for new products; (3) foreign areas furnish sources of supply for materials or resources which are scarce or nonexistent domestically; (4) wage and other production cost differentials make it more economical to manufacture abroad and import many items than to produce them domestically; and (5) domestic income taxes on the profits of foreign subsidiaries can be deferred until the profits are received, providing a tax-free source of capital for further foreign investment.

The conditions favorable to foreign investment have not been equally applicable to all parts of the world. There have been and are countries with political conditions so explosive as to preclude even consideration for business ventures. It would appear safe to
assume, however, that corporate managements have carefully considered all facets of the risk involved in foreign investment. If, having considered carefully, the managements have still made the investments, the vague references to "currency restrictions" and "unstable political or economic conditions" have been little or no deterrent. One of the recognized authorities on modern corporation activities has commented that "the large commercial corporations . . . have in the main been able to coexist with governments other than their own, outside their homelands, and to fulfill the economic tasks they have assumed."\(^\text{12}\) The life of a corporation is long and corporate management has demonstrated the ability to wait patiently through turbulent political-economic periods in order to enjoy later, more profitable ones.

The impetus for and the relative importance of foreign subsidiary companies have changed within the past twenty years. The estimated book value of direct, private United States long-term investments abroad in 1940 was $7.3 billions.\(^\text{13}\) By 1950, this estimated amount had increased to $11.8 billions or by about 62\%.\(^\text{14}\) Preliminary estimates for 1957 showed such investments at $25.3 billions, an increase of 114\% over 1950, and of 247\% over 1940.\(^\text{15}\) Similar estimates for 1958 and 1959 are not yet available but will undoubtedly reveal significant increases in foreign investment.


The attention devoted to reporting techniques for corporations with foreign subsidiaries has not kept pace with the increasing importance of foreign investment. As revealed by the examples cited in Chapter III, some of the leading United States corporations have adopted the practice of including all foreign subsidiaries in consolidated financial statements. The majority of corporations, however, have included only a portion of their foreign subsidiaries, perhaps Canadian only or Canadian and other Western Hemisphere companies, or have excluded all foreign subsidiaries. The result has been an incomplete portrayal of the financial position and operations of corporations with foreign subsidiaries and a lack of consistency in corporate reporting. Yet, the Committee on Accounting Procedure, in its 1959 study of consolidated statements, offered nothing new in reference to foreign subsidiaries. Instead, the Committee affirmed the opinions expressed in an earlier bulletin. These opinions were developed in circumstances existing in 1939 and great changes in business policies and accounting philosophy have taken place in the twenty years since then.

**Need for Appraisal**

The criteria for inclusion of a foreign subsidiary company in the consolidated financial statements need to be re-examined. In line with most of the standards of consolidation policy these criteria

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16 Committee on Accounting Procedure, ARB No. 51, *loc. cit.*, p. 42.
are negative in approach. They provide for exclusion of the subsidiary where certain conditions exist or appear to exist.

The instability or uncertainty of political conditions has usually been cited as a limitation to inclusion of a foreign subsidiary. There has been no definition, for financial reporting purposes, of what constitutes instability or uncertainty. Neither has there been any delineation of the circumstances in which the financial situation of a foreign subsidiary would or would not be affected by such unsettled conditions. There is some degree of lack of certainty as to future course of political activity present in every society, domestic as well as foreign. This has not concerned the accounting profession to any recognizable extent except for foreign operations. At the time this particular criterion was adopted in 1939, war was actually in progress in China and part of Europe with the apparent threat of spreading to most of the world. Such conditions are often referred to as "political" but the conflict was between nations rather than within nations.

Business organizations have proven their ability to stay relatively unaffected by sudden shifts in power and authority within a country. They have continued to function and add to the investment of assets in a country which has been in the midst of otherwise violent political upheaval. This is not to be construed to mean that no corporate subsidiary would be affected by political change in any country. Recent events in Egypt and in Cuba have been examples to the contrary. But the use of "political uncertainty" as a justification for the general exclusion of foreign subsidiaries from consolidated statements appears to be extreme conservatism.
In the absence of positive indications of loss in value of the investment in a foreign subsidiary, this criterion should not be used. Where a loss in value of foreign assets is deemed to have taken place as a result of political or legislative changes, accepted valuation methods should be applied to the assets included in the consolidated balance sheet. Such a loss should be recognized as a deduction from revenue on the consolidated income statement in the accounting period in which it was discovered to have occurred. Deliberate undervaluation of assets, as in the case of the investments in foreign subsidiaries, is equally as misleading as accidental overvaluation. Care should be exercised, therefore, to use the same asset valuation techniques for investments in foreign subsidiaries as are applicable for domestic subsidiaries.

A second limitation which has been proposed to restrict the inclusion of a foreign subsidiary in consolidated statements is concerned with control. This particular point, as a standard for consolidation generally, is to be considered in the next chapter. There appears to be no reason, however, for differences in treatment between domestic and foreign subsidiaries based upon whether or not sufficient control can be exercised to justify consolidation.

A third limitation on consolidation of a foreign subsidiary has been the existence of restrictions on the movement of foreign currencies and foreign exchange. This point has been the one most often referred to and has probably been the most important obstacle to the inclusion of foreign subsidiaries in consolidated financial statements.
The establishment of foreign exchange controls by a national government is done ostensibly to protect the balance of payments involved in foreign trade. The effect, generally, is to restrict the movement of capital out of a particular country and prevent national bankruptcy. The implications of such restrictions on the establishment and operation of a foreign subsidiary were impossible to foresee in the 1930's when exchange controls became widespread. It is not surprising, therefore, that a conservative approach was adopted for accounting for foreign operations, particularly since they constituted a relatively small part of business generally.

An intensive examination of the problems inherent in accounting for foreign operations generally has been reported in a monograph by Professor Samuel R. Hepworth of the University of Michigan. He has examined critically the varied forms that exchange controls may take. He pointed out that negotiation between a company and the foreign government involved often results in modification of the effects of such controls in individual cases. He found, further, that restrictions on the transfer of capital are usually much more strict than on the remittance of current earnings. He likened the investment in a foreign subsidiary to that in a domestic one, in terms of the concept of a "going concern," pointing out that liquidation of the investment is ordinarily not contemplated. Thus the more stringent restrictions on transfer of capital should no more preclude consolidation of a foreign

subsidiary than should the difficulties of liquidation of the plant and equipment of a domestic one. Professor Hepworth's opinion was:

... it certainly appears reasonable to conclude that restrictions on the free convertibility of foreign currency capital should have no effect on the propriety of the recognition by a domestic parent company of its equity in such earnings.\(^\text{18}\)

The existence of exchange controls and restrictions does not preclude the transfer of values. Those countries which have exchange controls may also have laws which control the movement of commodities. The two restrictions together, however, do not necessarily prevent the transfer of asset values from the foreign subsidiary to its parent. A quite common method employed to circumvent foreign exchange restrictions consists of exportation of materials, commodities, or manufactured products from the nation with the blocked currency to another foreign nation or to the domestic parent company. Professor Hepworth, having carefully considered the problems of accounting for foreign operations in general, reached this conclusion:

In summary it must be concluded that the effect on parent company control of a foreign subsidiary of foreign currency convertibility restrictions cannot be determined in any sort of generalized fashion, but rather the effect of such restrictions must be considered in each case and a decision reached as to the appropriateness of consolidation. Probably the most important point to be recognized is that the existence of restrictions is not of itself sufficient evidence to justify the conclusion that control is impaired sufficiently to make consolidation inappropriate. Examination of published financial data tends to create the impression that in many cases this is the line of reasoning which has been followed, with the result that foreign subsidiaries are excluded from consolidation when, in fact, there has been no effective restriction on the parent company's control of the subsidiary.\(^\text{19}\)

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\(^{18}\)Ibid., p. 125. \(^{19}\)Ibid., p. 166.
Summary

The limitations upon inclusion of a foreign subsidiary in consolidated financial statements appear to be inappropriate in terms of present circumstances. The considerations accorded to political-economic uncertainties in accounting for foreign investments have not served as deterrents to corporate investment in foreign countries. Neither has the existence of trade and currency restrictions noticeably dampened the enthusiasm for foreign investment. To the contrary, investments by United States corporations in foreign branches and subsidiaries have increased tremendously in the face of such unsettled conditions and restrictions as have existed.

Geographic location should be discarded as a recognized standard for consolidated statements. The present inconsistent practice, where some corporations consolidate all foreign subsidiaries, some include selected subsidiaries and exclude the rest, and some corporations exclude all foreign subsidiaries, is indefensible. The use of footnotes and explanatory schedules, resorted to as supplements to statements where foreign subsidiaries have been excluded, does not meet the requirements of a clear and useful presentation. The application of the conservative limitations which originated in the 1930's precludes the preparation of consolidated financial statements which fairly present the financial position and results of operations in conformity with other generally accepted accounting principles.

Where events subsequent to the establishment of a foreign subsidiary result in a recognized loss in value of the assets of the
subsidiary, appropriate asset valuation methods should be applied. The techniques which are recognized as applicable to domestic subsidiaries, coupled with accepted methods of accounting for foreign exchange transactions generally, would suffice. The profession of accounting has a demonstrated ability to meet the requirements of a fair presentation of financial information.
CHAPTER VI

CONTROL AS A STANDARD

The consolidated financial statement is a device for portraying the financial aspects of two or more affiliated companies as a single economic entity. The development of this reporting device has been based upon the premise that the dominant company in the group had "control" of the other companies in the group. Exercise of such control permitted the dominant company to direct the policies and activities of the group as though it were a single economic unit. The purpose of this chapter is to consider the concept of control as a requisite to the preparation of consolidated statements.

Theoretical Considerations

The existence of control over each affiliated company was inherent in the earliest presentations of consolidated financial statements. The dominant company of the group usually owned all of the outstanding shares of stock of each subsidiary company. Or, owned a large majority of the shares with the probable intentions of acquiring the remainder. This ownership of stock of course permitted the dominant company to dictate the membership of the board of directors and thereby control and direct the operation of the subsidiary company. As indicated in Chapter III, the presumption was that acquisition of an interest in another company was preparatory to the
eventual absorption of that company, by statutory merger or consoli-
dation, into a single legal entity. Consolidated statements, therefore,
portrayed a temporary stage in development.

The characteristics of business expansion have changed since
the inception of consolidated statements. The presumption of eventual
absorption of a subsidiary into the parent company is no longer valid.
The change has been a gradual one, with a variety of causes and ef-
fected. Associations now exist, between legally separate corporate
entities, which would not have been imaginable when the use of con-
solidated statements began. The philosophies of business ownership
and business competition at that time provided no basis for envisioning
the relationships to be found today.

The profusion of inter-corporate relationships which have
developed over the years has engendered concern as to what constitutes
control for purposes of justifying inclusion of an affiliated company
in the consolidated statements. In the limited literature available
on the subject of consolidation policy more attention has been devoted
to the question of control, in all its ramifications, than to any other
point. This attention is undoubtedly justified. Control can be
achieved, either temporarily or permanently, by such a great variety
of means as to defy development of a set of definitive measurements
to fit all cases. Efforts to do so have generally established con-
ditions of control in a manner which can be described as indirection.

No attempt will be made here to define or describe all that
may constitute control. Such an attempt would no doubt fall short of
its goal. The existence of control over an affiliated company as a
requisite to inclusion of that company in consolidated statements is the pertinent point. The ways in which control may be achieved are of lesser importance.

Kohler, in 1937, referred to control in defining consolidated statements:

A "combined" financial statement is the summation of the financial statements of two or more units having a common control. If the control lies in one of the units, as in the case of the controlling-company-subsidiary relationship, the statement is a "consolidated" statement . . .

He then described control:

"Control" means power, as a rule actually exercised, to choose at least a majority of the board of directors. It is usually direct: that is, evidenced by the ownership of a majority of the subsidiary's outstanding voting capital stock. However control may also be indirect: the possession of less than half of the voting stock may be sufficient to insure the domination of meetings of stockholders, and hence the election of a majority of the board of directors, provided that there exists, to the necessary degree, any one or more of the following conditions:

(1) Ability to obtain proxies from other stockholders.
(2) Inactivity of stockholders who take no part in meetings, by attendance or through proxies.
(3) Ownership of voting stock by subsidiaries, directors, officers, employees, nominees, or other persons having subordinated interests.
(4) Possession of a lease or other contract with a corporation which carries with it the virtual ownership of the corporation's assets without any necessary ownership of capital stock.

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2 Ibid., p. 64.
It should be noted that the emphasis here is upon the ability of one company to direct the operations of another company. There is no expressed provision that there must be a beneficial interest in the assets of the controlled company or in its earnings. There is the implication, however, that domination of the affiliated company is to the benefit of the parent company. The benefit was not described but it should be recalled that Kohler would include in consolidated statements only those companies which had operations integrated with the group. This could imply, therefore, that the parent and majority-owned companies would need to benefit at the expense of the minority-owned but controlled company.

Moonitz enlarged upon the discussion of control as a requisite to the preparation of consolidated statements. His views were generally in line with those of Kohler. He rejected percentage of stock ownership as the determinant of control as "not in itself satisfactory as a standard indicating the precise extent of the area of consolidation." As to the possibility of controlling a company with ownership of less than a majority interest he said this:

"Where the available data are such as to satisfy the accountant that a minority holding carried with it complete domination of the board of directors, and the continuing power to carry into action the policies of the minority group, centralization of control exists and consolidation of accounts is proper. In the absence of indications of this nature, however, the conclusion is justified that no entity exists which can be properly reflected through consolidated statements."

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3 Ibid., p. 64. 4 Moonitz, op. cit., pp. 29-30.
5 Ibid.
He pointed out that objection to such a conclusion might be raised, so he defended it by saying:

The essential objective of consolidated statements is to present an accounting projection of the combination as a whole—all its assets and all its debts, as well as its earnings. To whom the earnings accrue and what groups possess an interest in the combination are then reflected in the distribution of consolidated net income and the allocation of consolidated capital.\(^\text{6}\)

Moonitz, as well as Kohler, placed great emphasis upon integration of operations as requisite to inclusion in the consolidated statements. It appears to be upon this supposition, in fact, that he justified the inclusion of the minority-held but controlled affiliated company.

The Committee on Concepts and Standards concentrated upon the existence of a "dominant central financial interest" and upon the application of "administrative control."\(^\text{7}\) The term "dominant central financial interest" was not defined. The Statement indicated that "usually the presence of this interest is clear-cut and recognizable."\(^\text{8}\) The Committee attempted to clarify the procedure where it is not obvious:

When, however, its existence is not obvious its evaluation involved consideration of the amount and type of share ownership among affiliates, representation on the board of directors, restrictive clauses in bond and share contracts, restrictive legislation, etc. Ownership of a substantial percentage of voting shares is ordinarily prerequisite to the existence of such interest, but, taken alone, share ownership may not

\(^{6}\) Ibid.


\(^{8}\) Ibid.
in specific cases be sufficient for its establishment and continuance . . . In most cases, however, ownership of a majority of the voting shares outstanding is sufficient to establish a *prima facie* case that a dominant central financial interest exists.

The conclusion to be most readily obtained from this is that ownership of more than 50% of the voting shares would provide the basis for consolidation; however, "a substantial percentage of voting shares" might refer to less than 50% which would mean that this Committee was in concurrence with the position of Kohler and Moonitz. The term "administrative control," described as "a quality or condition" was used in reference to the integration of the affiliate with the activities of the whole enterprise. This, too, was in conformity with the recommendations of Kohler and Moonitz.

As was indicated in Chapter III, little attention was directed to the problems of consolidation policy in the professional literature prior to the middle 1930s. Kohler's study in 1937 constituted the first apparent effort to point up the problems. Moonitz's monograph was published in 1944 and the Committee on Concepts and Standards' Statement in 1954. The three studies spanned a period of seventeen years during which the parent-affiliate company relationship should have received a considerable amount of scrutiny from the accounting profession. Each of the studies approved inclusion in the consolidated statements of an affiliated company, less than 50% owned, provided the affiliate was otherwise controlled and was an integral part of the overall economic unit. This provision was specifically

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stated in the studies by Kohler and Moonitz, implied in that of the Committee on Concepts and Standards. The theoretical implications of the provision require examination.

**Effect Upon the Financial Presentation**

The inclusion of a given subsidiary in the consolidated statements of an economic entity has certain effects obvious to one familiar with the technique of preparing such statements. The net assets of the subsidiary are substituted on the balance sheet for the asset account in which the dollar value of the investment in that subsidiary had appeared. Asset and liability accounts in which inter-unit transactions were reflected are eliminated to avoid double counting. The net worth of the subsidiary company assets is represented by a combination of majority-shareholders' equity and minority-shareholders' equity. The effect upon the balance sheet is generally to increase in dollar value the assets, the liabilities and the equity of shareholders in the economic entity. On the income statement, the revenues and expenses of the subsidiary are added to those of the remainder of the entity, again with eliminations of inter-unit transactions to avoid duplication. A variation in percentage of shares of the subsidiary company stock owned by the parent company would have no effect on assets, liabilities, revenues, expenses, or net income revealed on the consolidated statements. The only effect of such a variation would be in the allocation between majority shareholders and minority shareholders of the interest in net assets and net income of the whole group. Assuming all other factors to be equal the consolidated financial report of a group of companies would reveal exactly the
same facts whether a given subsidiary were controlled or not con-
trolled, integrated or not integrated, homogeneous or not homogeneous. This would be true no matter what percentage of ownership was held in the subsidiary company, 1%, 100%, or any percent between.

The purpose to be served by financial statements is the por-
trayal of the financial position at a given time or at given times and the results of operations for a period. The balance sheet was designed to reflect the assets employed in the business and the sources from which those assets were obtained, or the claims against the assets which ultimately must be satisfied. The income statement was designed to reflect the revenues produced by the employment of the assets invested, the expenses incurred in the acquisition of such revenues, and the resulting net gain or net loss in asset value, applicable to a particular period of time. There is no apparent variation in portrayed financial position or results of operations which would result from the existence or the absence of administrative control or integrated activities. There appears to be, therefore, no basis for requiring that these be requisite conditions for the inclusion in consolidated statements of a subsidiary in which the ownership is less than majority ownership.

Despite the basis in theory for consolidating a minority-owned affiliated company, practical adoption has been practically nonexistent. Standard textbooks and reference books in accounting usually refer to a requirement for majority ownership of voting stock to justify inclusion in consolidated statements. This position is supported by the contention that majority ownership is necessary for continued legal and practical control. Unfortunately it has not been made entirely
clear why control is necessary. One can surmise, however, that this attitude had its origin in the implication that acquisition of stock in an affiliated company was but the first step toward eventual legal absorption by merger or statutory consolidation. Such a change in legal status would require acquiescence of the owners of at least a simple majority of the shares outstanding of the affiliated company.

The Securities and Exchange Commission has left nothing to be interpreted concerning its position in regard to control. Rule 4.02 of Regulation S-X provides that "the registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary." The Committee on Accounting Procedure apparently concurred with this requirement in 1959. The Committee stated that consolidated statements "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." The Committee than explained that "the usual condition for a controlling financial interest is ownership of a majority voting interest." There was no indication in this statement of the propriety of inclusion of a less-than-majority-owned affiliated company in the consolidated statements. Neither was there any indication of what might constitute an other than "usual" condition for a controlling interest.

It is clear that some criterion or criteria must be established to determine the propriety of inclusion or exclusion of an affiliate

10 Rappaport, op. cit., p. 266.
11 Committee on Accounting Procedure, AAB No. 51, loc. cit., p. 41.
12 Ibid.
for consolidated statement purposes. It is also clear that one factor to be considered must be the ownership by a company or companies in the group of a substantial amount of the outstanding stock of the affiliate in question. There appears to be unanimity of opinion that ownership of more than 50% of the outstanding voting stock in an affiliated company is enough to qualify that company for inclusion in the consolidated reports. In the interest of consistency in reporting, therefore, there should be included in the consolidated statements the accounts of every subsidiary company which is more than 50% owned, provided all other requisite conditions are met. Failure to do so exposes accounting to criticisms such as this:

... From management's standpoint one of the advantages of having important unconsolidated subsidiaries is that their accumulated earnings may be drawn upon in the form of special dividends to bolster up the parent company's reported results in a poor year.\(^\text{13}\)

As for minority-owned affiliated companies, it appears to be impossible to generalize. There is no obvious reason why ownership of 49.9% of the affiliated company's stock would make inclusion inappropriate where ownership of 50.1% would make inclusion appropriate. The burden of proof, however, should be on the parent company to justify the inclusion of a minority-owned affiliated company in its consolidated reports.

**Alternatives in Presentation of Unconsolidated Affiliates**

In cases where there is a substantial interest in an affiliated company, but less than majority ownership, and the affiliated company

is excluded from consolidation, the problem of adequacy of presentation remains. Two alternative methods have been and are employed to reflect the asset value of the investment in the stock of a non-consolidated affiliated company. One of these two methods, normally called the "cost" method, maintains the original acquisition cost of the stock in the affiliate as the indicated value for the asset. Or, perhaps, presents the acquisition cost reduced by any recognized decline in value of the investment. The other method is variously referred to as the "actual value," "accrual," or "equity" method. It reflects the original acquisition cost of the stock in the affiliate adjusted for the applicable portion of any changes in the net assets of the affiliated company since the stock was acquired.

The cost method is the more conservative of the two alternatives. It has been the more widely used, by a great margin, probably because it follows the time-honored principle that historical cost is the most appropriate basis for asset valuation. Its use provides recognition of the rate of return on the investment in the stock only to the extent of dividends declared by the affiliated company. For this reason the use of the cost method results in obscuring the real effectiveness of the investment. This is sometimes the case where the affiliated company is experiencing "temporary" business reverses which are expected eventually to be corrected. The accepted practice for the valuation of a long-term investment, where a fair market value decline has been noted, is to continue to carry the investment at cost until the decline has been determined to be permanent. In many cases this could be for a period of several years and meanwhile would not reflect a change in earning capability. The obscuring of the
effectiveness of the investment is more often the result where the affiliated company, experiencing highly profitable operations, is expanding by the reinvestment of earnings and paying only token dividends or none at all. The continued valuation of the investment at cost is in line with the conservative principle that gains should be recognized only when realized. As illustrated by the practical examples cited in Chapter III, the result is often an asset whose stated value (cost) is far below its apparent actual value. Further, the income recognized, measured by dividends received, is not a true reflection of the earnings accruing as a result of the investment.
The use of footnotes and auxiliary schedules has been recommended to provide supplementary information to augment the cost method. The advocacy of such adjuncts to the statements would appear to be recognition that the use of the cost method is inadequate as a reporting technique.

The equity method has been a proposed alternative to the cost method as a basis of valuation of the investment in an unconsolidated affiliated company. It has been criticized as being contrary to the generally accepted principles that increases in the value of assets should not be recognized in the accounts until realized. Realization would require that there be an exchange of values. Since there will have been no exchange of values until the equity in the affiliated company has been sold or until the earnings of that company have been remitted to the investing company, the use of the equity method has been labeled unrealistic or unconservative. As a result, apparently, there has been a reluctance on the part of accountants to use the method, and it has not been widely adopted.
The equity method should be defended on the basis of its reflecting the changes, increases or decreases, which have occurred in the claims, represented by the shares of stock owned, against the assets of the affiliated company. The method would appear to be no more at variance with generally accepted principles of asset accounting than the accrual of interest or any other claim, such as for a refund of taxes previously paid. If it can be assumed that the affiliated company follows accepted accounting procedures the recognition of changes in the equity in net assets of the affiliate would not appear to be unconservative. It should be recognized as a useful, meaningful technique for accounting for company assets employed in a way which is different from that of other assets. The investment in an affiliated company is not an asset used in the primary trade or business. It is, however, normally intended as the employment of assets to produce a satisfactory rate of return on the investment. Failure to recognize that return, as it accrues, whether favorable or unfavorable, cannot be defended on the grounds of "conservatism." Again, deliberate understatement of asset values and revenue produced is as inexcusable as deliberate or accidental overstatement.

The Committee on Accounting Procedure indicated that, in their view, the equity method was "the preferable method" for accounting for the investment in unconsolidated subsidiaries.¹⁴ Two members of the Committee assented to the statement with the qualification that, in their opinion, the equity method should be the "only acceptable method

¹⁴Committee on Accounting Procedure, ARB No. 51, loc. cit., pp. 46-47.
of dealing with unconsolidated subsidiaries in consolidated statements . . . \footnote{15} The recommendation of the Committee is in reference only to the investment in a "subsidiary" company. The Committee does not specifically state but implies that a subsidiary is a company controlled by the ownership of more than 50% of the outstanding voting shares. The Committee's stand, if adopted, would provide an obvious improvement in the reporting practices which have been in use. It appears, however, to still provide the basis for continued inconsistencies in the presentation of consolidated financial statements. It has been proposed here that the inclusion of an affiliated company in consolidated statements should be required in all cases where a majority ownership exists. This would eliminate the problem of determining an appropriate basis for valuation of the investment in an unconsolidated, majority-owned subsidiary company. It was also suggested that it would be appropriate to include a minority-owned affiliated company in consolidated statements when such treatment appears justifiable. It is further recommended that, where a minority-owned affiliated company is excluded from consolidation, the investment value to be shown on the consolidated balance sheet should be determined by the use of the equity method. Only by such treatment can the effectiveness of the investment be adequately and consistently disclosed.

\footnote{15} Ibid., p. 50.
Modifications of Control

There were listed in Chapter III a series of "conditions" which would provide for exclusion of an affiliated company from the consolidated statements. It was concluded that with the exception of unrelated operations, discussed in Chapter IV, and foreign location, discussed in Chapter V, these conditions were attributes of control. For that reason they qualify for discussion at this point.

One of the variants referred to "control being exercised only temporarily." It is difficult to visualize why and how "control" was acquired. If the reference were to voting control without majority ownership, the affiliate should be included in consolidated statements only if it can be proven that this would result in the best presentation of the entity's financial circumstances. If majority ownership has been obtained, for whatever devious reason and for whatever "temporary" length of time, the affiliated company should be consolidated in the interest of consistency between financial entities. The possibility of existence of this "condition" appears to be practically academic.

A second variant concerned control which had been legally restricted, through receivership or by injunction. Such restrictions usually preclude disposition of the company's assets but not the employment of those assets in the ordinary course of business. There appears to be no way in which such legal restrictions could invalidate the financial statements in which such an affiliated company had been included. A subsidiary company should not be excluded from the statements because of legal restriction on the exercise of control since
exercise of control cannot affect operating results already obtained and a financial position already achieved.

A third restriction was suggested where control was practicable but was not being exercised. Such a condition might exist where the stock was held in trust by a bank or purchased as an investment by an insurance company or an investment company. The impropriety of consolidation in those cases is recognized and is not under consideration here. If such a condition existed where the stock was owned by an industrial firm, the absence of control should not be a factor. If a majority ownership exists, the subsidiary should be included in the consolidated statements.

A fourth suggested condition was that if the interest in the affiliate were about to be disposed of or reduced, the affiliate should be excluded. This would appear to be capable of explanation by footnote to the statements. The purpose of financial statements is to portray what has happened and what the present conditions are. The contrast between consolidated statements before and after the actual change in circumstances would be no greater than between prior consolidated statements and those from which the subsidiary has been eliminated in anticipation of reduced ownership. The disadvantages, if any, arising from inclusion of the company about to be disposed of would probably be offset by the avoidance of the confusion which interpretation of this condition might provide.

A fifth restriction upon consolidation which has been offered is the existence of a large outside interest in the affiliated company. There are practical examples where the affiliated company has achieved
such success in operations that it has grown to the extent of exceeding the size of the parent company. Under such circumstances, the minority interest on a balance sheet consolidating the two companies may be almost as large as the majority equity. Such a presentation does not destroy the validity or usefulness of the consolidated statements although it may appear peculiar. This condition does not appear to be an appropriate reason for exclusion of a subsidiary from the consolidated statements. If a majority ownership of the affiliated company exists, the affiliate should be included in the statements in the interest of consistency of treatment.

The last of the conditions, suggested as reasons for exclusion and not covered elsewhere in this study, is concerned with an affiliate whose fiscal year does not coincide with that of the rest of the group. This would appear to be a condition easy to correct. If control over the affiliate is available, through stock ownership or otherwise, the affiliate should be forced to change its fiscal year. There appears to be no reason for accepting difference of fiscal years as a basis for exclusion of an affiliated company from the consolidated statements.

Summary

Control is a valid standard for determination of the appropriateness of including a given affiliated company in the consolidated financial statements. It is usually the control which is available because of the ownership of more than 50% of the outstanding voting shares of the affiliated company. There are, perhaps, circumstances in which ownership of less than 50% of the affiliate would not
invalidate the affiliate's inclusion in the statements. The burden of proof, however, should fall upon the corporation which presents statements that include a minority-owned affiliated company.

There should be consistency of reporting as between corporate entities in regard to the presentation of consolidated financial statements. Lack of homogeneity of operations and foreign location were discarded as barriers to consolidation, in Chapters IV and V respectively, in the interest of consistency. It is here proposed that where a majority of the outstanding voting shares of stock of an affiliated company are owned by member companies of an economic group, the affiliated company should be included in the consolidated statements. Ownership, as an indication of control, then becomes the sole criterion or standard for consolidated financial statements. Where there exists majority ownership, inclusion of the subsidiary should be obligatory. Where there is minority ownership coupled with compensatory factors, inclusion of the affiliate should be permissive but subject to justification. If a minority-owned affiliated company is to be excluded from the consolidated statements, the equity method should be used as the basis for valuation of the investment account carried as an asset in the consolidated balance sheet.
CHAPTER VII

ASSOCIATED COMPANIES

An "associated company" is a corporation which is owned in equal shares by two other corporations. The parent companies may be otherwise direct competitors in the same industry or may be in different industries. The increasing use of the associated company as a device for corporate expansion is an anomaly. This arrangement, in the nature of a joint venture for the mutual benefit of the two investing companies, was not contemplated in the development of the techniques of consolidated financial statement preparation. It provides a problem of financial reporting for the investing corporation which is unique. For that reason, this chapter is devoted to an examination of the appropriate form for disclosure of an investment in an associated company.

The Absence of Theoretical Discussion

The existence of the associated company has been all but ignored in the literature on accounting. The Securities and Exchange Commission has given some slight recognition to this form of relationship in Regulation S-X where such a company is described as a "fifty per cent owned person" and defined as

... a person in respect of which the registrant owns directly or indirectly approximately 50 per cent of the voting securities and approximately 50 per cent
of the voting securities of such person is owned directly or indirectly by another single interest. 1

The only accounting treatment prescribed by the Securities and Exchange Commission, however, is that prescribed for unconsolidated subsidiary companies generally. The fact that there is a lack of attention directed at the associated company would appear to imply that both the number and materiality of such companies are insignificant. Indications are to the contrary. There appears to be a trend toward more widespread use of the device for the pursuit of the material aims of two otherwise unrelated corporations. Further, at least in some instances, the results obtained by the investment in an associated company have contributed significantly to the earnings potential of the investing company.

There is one apparent reason why the accounting profession has devoted so little attention in the past to the existence of associated companies. The alliance of two independent, often competitive, corporate entities through the medium of mutual investment did not fit the popular concept of free competition. Public opinion had inspired legislative action early in the nation's history to curtail business combinations or agreements designed to restrict competition. Such joint ventures as the associated company were probably considered to be a temporary expedient, subject to possible legal action, short-lived and otherwise unimportant. Investment in an affiliated company without the capability of dominating and controlling its policies and operations was not in conformity with the

1Rappaport, op. cit., p. 238.
prevailing theory of corporate expansion. Accountants in the past were perhaps justified, therefore, in relegating the investment in an associated company to the status of any long-term investment in a non-controlled company.

**Increased Use as a Means of Expansion**

The associated company today appears to be anything but an unimportant, temporary means of business expansion. A limited survey of the corporate annual reports of well-known domestic companies reveals that a large portion indicate ownership of exactly fifty percent of one or more affiliated companies. Many state, in the commentary on operations, that such affiliates have only recently been established. Unfortunately, most of the companies provide little or no information as to the results obtained by the investment in individual non-consolidated affiliates. Many do not specify the amount of that investment. Reference to the relative amounts involved, where the information is provided, indicates that such investments often materially affect an appraisal of the investing company. The use of footnotes, and other supplements to the statements, to reflect the status and effectiveness of the investment in an associated company, is unsatisfactory. The accounting profession needs to devise techniques for incorporation of the information into the financial statements.

It would be impractical to attempt to discuss here the variety of motives which may have given rise to the widespread adoption of the associated company device. It will require several
years of experience with such arrangements to determine whether the establishment of such "partnership" associations is merely temporarily expedient or will prove to be a method of expansion of a lasting nature. There are, however, existing circumstances which have contributed to the increased use of the associated company for both domestic and foreign ventures.

Discoveries of new chemical compounds, developments of new combinations of basic materials with exotic properties, practical applications of previously known but considered useless knowledge, all of these have contributed to disruption of the established pattern of industries. Remarkable advances have been made in the development and improvement of new products and materials, some of which have drastically reduced demand for the output of a whole industry. As a result, companies have had to choose between conceiving a substitute for obsolete products and going out of business. In some instances, scientific advances have provided the basis for the birth of an entirely new industry. Plastics, electronics, synthetic fibers, and heat-resistant materials are products which have provided the source of phenomenal growth for new companies and old.

Established companies have ventured into new product areas by many methods. If a company possessed the technical and productive know-how, it could establish a new division or subsidiary company to exploit the product potential. Or, perhaps, it could purchase a company already established and provide the capital and managerial personnel to expand its operations. However, some of the new products required knowledge, techniques and experience, to produce or supply
materials or provide a market for the product, which could only be found outside the particular industry. The associated company apparently has provided a convenient vehicle for combining the complementary resources of companies from two separate industries. The resultant company might well form the nucleus for a third industry. If the venture should prove to be unsuccessful, the risk would have been shared and the loss to one particular company thereby reduced. Corporate reports reveal a number of cases, for example, where some of the investing companies have agreed, as a form of credit guarantee, to purchase one-half of the associated company’s production, at a price sufficient to cover all costs, for a specified period of years.

The associated company has been employed to conduct operations in foreign countries. As was mentioned in Chapter V, while foreign governments may invite and welcome investment by outsiders, there are many which have established safeguards to reduce or prevent exploitation. One such safeguard limits the percentage of total ownership, in a company authorized to conduct operations in the foreign country, which may be owned by outsiders. Another safeguard controls business ventures by issuing licenses only to companies already operating within its boundaries. A domestic company which wishes to inaugurate operations in that country must do so in conjunction with a company which can obtain the necessary permits. In either case, the associated company device would prove effective. Additional reasons may also be found for its use. The advantages of combining skills and resources of two different companies may be found in the foreign venture as well as the domestic one. The foreign partner may furnish a source of supply for materials or other components.
or the marketing skill necessary to successfully penetrate a foreign market. Or, the domestic partner may furnish necessary capital, technical assistance or the channel for distribution of foreign products into the domestic market. Whatever the reasons which prompt their inception, the existence of foreign as well as domestic associated companies is an established fact.

Lack of a Generally Accepted Method of Reporting

Adaptation of traditional reporting techniques to provide for adequate disclosure of the investment in an associated company has been restrained. The nature of this arrangement raises the question of the existence of "control" by the reporting company, the basic requisite for inclusion of an affiliated company in consolidated financial statements. While one of the two "parent" companies might exercise greater influence upon the policies and activities of the associated company than the other, continued dominance might be difficult to achieve.

The existence of an economic entity which included the associated company could be denied on the premise that it was a part of two economic entities, not just one. The inclusion of the same assets and liabilities, revenues and expenses, in the consolidated statements of each of the two investors would be the antithesis of the philosophy underlying presentation of such statements.

The exclusion of an associated company from consolidated statements has been the prevailing practice. The absence of a majority ownership of the voting stock of the affiliate has presumably been the primary cause. Further reason has been provided, however, by the
Securities and Exchange Commission's express restriction against consolidating a company in such cases and its specification of treatment for unconsolidated subsidiaries and associated companies. Rule 4.05 of Regulation S-X provides that,

A statement shall be made of the amount of any difference between the investment of the parent and its consolidated subsidiaries, as shown by their books in the unconsolidated subsidiaries and fifty-percent owned persons for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, and fifty-percent owned persons, as shown by the books of the latter.²

This provision implies that valuation of the investment in such companies, which would be carried among the assets in the consolidated balance sheet, would be at cost. This, too, has been the prevailing method used for valuation of an unconsolidated subsidiary or associated company in published reports. The failure of the cost method to provide adequate disclosure of an investment in an affiliated company was discussed in the previous chapter and is, of course, applicable to the associated company as well.

The equity or accrual method of valuation for the investment in an associated company would be an improvement over the use of the cost method. The method has been used to a limited extent by companies to portray the status of an investment in a majority-owned but unconsolidated subsidiary. It normally has not been advocated or adopted for use where only a minority ownership in an affiliated company existed. A notable exception to the rule has been the investment by E. I. Du Pont De Nemours & Co. in General Motors Corporation.

²Rappaport, op. cit., p. 274.
Although it owns less than 25% of the voting shares it has used the equity method since 1925. The materiality of the investment is illustrated by the fact that at December 31, 1959, the equity value of the investment was $1,055,250,000, more than one-fourth of Du Pont's total assets of $3,970,102,098. The Atlas Powder Company in its 1959 report carried as one of its investments "50%-Owned Companies" stated as being "at underlying net asset value (Note 1)." The note stated, in part:

In February 1959 the company acquired 50% of the outstanding capital stock of Solar Nitrogen Chemicals, Inc., a corporation organized to purchase an established, integrated industrial complex manufacturing anhydrous ammonia and related products. The investment therein and in Honeywell-Atlas, Ltd. (another non-consolidated 50% owned company) is carried in the consolidated balance sheet at underlying net asset value. Atlas' share of the net income of these companies (less income tax which would have been payable thereon if received as a dividend), $472,000, has been included in consolidated earnings for the year and in consolidated retained earnings at December 31, 1959.

As stated before no exhaustive survey of reporting practices is implied here but this is the only example of the use of the equity method for reporting an investment in associated companies noted in examining the most recent annual reports of several hundred companies, a great many of which disclosed such an investment. While one example does not denote a trend it was interesting to note that no exception to the

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4 Ibid., p. 32.
6 Ibid., p. 19.
adoption of the equity method was taken by the independent certified public accountants.

A survey of published annual reports reveals many examples of the use of the cost method to account for the investment in associated companies. Careful analysis of the report, including footnotes and the general commentary, further reveals that material amounts of increased asset value and earnings are inadequately disclosed. In many cases such amounts were not disclosed. Where they were disclosed it was often in such a way as to make appraisal of their effect on the financial position and results of the investing company practicable only for a trained accountant. One example will be illustrated here and discussed at length. It is of interest for a number of reasons, including (1) the success the associated company has achieved, (2) the material effect that success has had on the investing companies, (3) the efforts each of the companies has put forth to disclose the effects of the investment on its own financial status, and (4) the novel statement technique one of the companies has been using.

An Example of the Degree of Materiality Possible

The Chemstrand Corporation was formed in 1949 as a jointly-owned affiliate of American Viscose Corporation and Monsanto Chemical Company. The company established two plants for the production of synthetic "miracle" fibers. It has been eminently successful and is now the world's second largest producer of chemical textile fibers.7

The Chemstrand Corporation has earned $82,730,000 after taxes and paid its two "parent" companies a total of $10,000,000 in dividends in its ten years of operations. The maximum apparent investment in Chemstrand by the two "parent" companies was $55,000,000, in the form of paid-in capital and subordinated notes. Chemstrand has repaid $20,000,000 of the subordinated notes so that, at December 31, 1959, the investment had been reduced to $35,000,000 in total or $17,500,000 for each "parent" company. The equity of each "parent" at December 31, 1959, was $53,865,000 compared with the cost of its investment of $17,500,000, an increase of $36,365,000.

The importance of the investment in Chemstrand to American Viscose Corporation is obvious upon examination of its annual report to stockholders. Its unrecorded equity in the net assets of Chemstrand, $36,365,000, was 15.0% of the recorded equity of the shareholders of American Viscose Corporation at December 31, 1959. In 1959, the dividends received from Chemstrand were $2,500,000 before taxes, $2,305,000 after taxes. This latter amount was 17.8% of American Viscose Corporation's own income after taxes and 15.1% of its total net income for the year. The following tabulation shows, for each of the last five years, the net earnings after taxes of American Viscose Corporation, the Corporation's share of the earnings retained by Chemstrand each year reduced by the taxes which would be

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paid if received as dividends, and the percent the latter earnings, unrecorded, were of those recorded:

<table>
<thead>
<tr>
<th>Year</th>
<th>Own Earnings After Taxes</th>
<th>Share of Chemstrand Earnings Retained</th>
<th>Percent of Recorded Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1959</td>
<td>$15,231,000</td>
<td>$8,795,000</td>
<td>57.7%</td>
</tr>
<tr>
<td>1958</td>
<td>6,950,000</td>
<td>6,157,000</td>
<td>88.6</td>
</tr>
<tr>
<td>1957</td>
<td>8,408,000</td>
<td>8,673,000</td>
<td>103.2</td>
</tr>
<tr>
<td>1956</td>
<td>14,909,000</td>
<td>5,760,000</td>
<td>38.6</td>
</tr>
<tr>
<td>1955</td>
<td>24,709,000</td>
<td>6,485,000</td>
<td>26.2</td>
</tr>
</tbody>
</table>

The materiality of the unrecorded earnings is beyond question. No mention is made of them in either the financial statements or the "Notes to financial statements." Yet, the independent certified public accountants state that in their opinion "the accompanying statements present fairly the consolidated financial position of American Viscose Corporation and its subsidiaries at December 31, 19XX and their results of operations for the year, in conformity with generally accepted accounting principles . . ."10 The Corporation, in other portions of the report, pointedly includes the earnings of The Chemstrand Corporation, together with other associated companies, in indicating the earnings per share. A curious shareholder trying to calculate this same figure, from information contained in the financial statements, could not do so. His reaction, as to which figures "present fairly the results of operations," those in the front of the report or those in the accountant-approved statements, should be to question the

purpose of the independent accountants. The only apparent defense for failure to include the earnings of the associated companies is that traditional accounting procedures have been followed. If this is true, no better argument could be advanced for changing traditional procedures so that the information portrayed in financial statements would present the facts.

The importance of its investment in The Chemstrand Corporation is not quite so great in the case of Monsanto Chemical Company but is still material. Monsanto's equity in the earnings retained by Chemstrand, $36,365,000 at December 31, 1959, was about 8.2% of its own recorded equity of shareholders. Its unrecorded share of the unremitted earnings of Chemstrand, adjusted for the applicable income taxes if and when declared as dividends, was $8,795,000 for 1959, or 18.0% of its reported earnings after taxes of $48,977,000. For 1958 its share was $6,157,000 or 17.8% of its $34,550,000 reported earnings after taxes. In addition the Company has had an interest in four other associated companies for which it did not report detailed financial information. The focus of attention here is not so much upon the materiality of Monsanto's interest in its associated companies as it is upon the financial reporting technique the Company has employed.

An Exceptional Method of Reporting

Since 1955, Monsanto Chemical Company has included two sets of statements in its annual report. One set of statements, to which the opinion expressed by the independent certified public accountants
has been specifically limited, has shown the "consolidated financial position" and "related statements of consolidated income and surplus" for "Monsanto Chemical Company and its domestic and Canadian subsidiaries." In the second set of statements each has been headed as follows:

**SHAREOWNERS' NET INTERESTS**

**IN PARENT COMPANY, DOMESTIC AND FOREIGN SUBSIDIARIES AND 50% OWNED ASSOCIATED COMPANIES**

Consolidating Only That Percentage of Associated Companies which is Represented by Monsanto Shareowners' Equity

This second set of statements has been preceded by a full-page explanation of why the statements were considered necessary, what companies were included, the income tax treatment accorded the operating results, and the basis for currency exchange conversion for the foreign affiliates. The reason stated by Monsanto Chemical Company for the supplementary statements is as follows:

... Monsanto's shareowners' true assets and true earnings include all assets and earnings of foreign subsidiaries and portions of other companies' assets and profits which are not given full effect in normal consolidations. To present such overall equities, the following pages contain consolidated financial statements and other data respecting the Company and its domestic and foreign subsidiaries, together with that portion of the assets, liabilities, sales, income, employees, additions to property and other data, which are represented by our 50 per cent ownership in associated companies. (Italics mine)


12 Ibid., pp. 16-19.

The two sets of statements are presented in contrasting colors to distinguish one from the other. Interestingly, for the first two years the independent auditor's opinion letter could have been construed as covering both sets of statements which preceded it. In the year 1957 and for succeeding years the opinion letter specified the pages of the report to which the opinion was expressed. The supplementary statements containing the associated companies were not included.

Contrary to Traditional Consolidation Technique

As indicated above, the data presented for the associated companies, in the second set of financial statements, was only 50% of the amount reflected on the associated companies' books. The other ownership, the equivalent of the "minority interest" in a subsidiary, has not been represented. This is not in keeping with the traditional principle that all of the assets, liabilities, revenues, expenses, etc., of the affiliated company should be embodied in the consolidated statements and that the minority interest in the resulting net income and owners' equity in assets should be set forth. This principle was based upon the concept of an economic entity, each element of which was a part of an integrated group of companies. As such, all of the assets and all of the activities of each company in the group were assumed to be employed for the eventual benefit of the dominant company in the group and, by implication, at the expense of the minority interests. If, as concluded in Chapter IV, integrated operations of the group of companies is no longer a valid criterion, the principle should be viewed in that perspective.
The purpose of a balance sheet is to portray the assets employed in the business endeavor and the sources from which those assets have been obtained. The purpose of an income statement is to portray the revenues produced by the employment of the invested assets, the expenses incurred in producing those revenues, and the net change in asset values which results and accrues to the benefit of the investors. The detailed classifications of assets, liabilities, owners' equities, revenues, and expenses, presented in financial statements, are in detail presumably because such a presentation is more useful than the statement of just the total owners' equity at the year-end or just the net income for the year. If this is true, the most useful presentation of financial information for a company would include the accounts of all of its affiliated companies as well as its own. This is the fundamental reason for the use of consolidated statements. The minority interest in a subsidiary company is presumed to make no similar incorporation of the subsidiary company's accounts in financial statements. This assumption normally would not be valid for the other investor in an associated company. In the case of associated companies the assets are employed for the benefit of two economic entities, not just one. The other investor should have an equal interest in portraying its total effectiveness in the employment of its assets. Thus, the same amounts would be included in the consolidated statements of two separate companies, each of which would include the equity of the other as a part of "minority interests." Such a duplication of financial information would not be detrimental to the usefulness of the statements presented by either of the
investing companies. Neither would it be contrary to the principles for preparation of consolidated statements except to dismiss majority ownership, and the coincident control, as a requisite to inclusion of an affiliate in such statements. It might, however, be misinterpreted by the public and denounced as accounting trickery. It undoubtedly would complicate even further the accumulation of useful, statistical information in regard to national income accounting.

**Consideration of Control**

The element of control, as a standard to determine the appropriateness of inclusion in consolidated statements, is interesting to consider in the case of the associated company. Majority ownership as a measure of control is, by definition, not present and the same would normally be true of the ability to elect at will a majority of the board of directors. This, at first, would appear to indicate the existence of a lack of control. However, ownership of exactly 50% of the voting stock provides assurance that control does exist and that it is lasting. Effective control is as much achieved by being able to restrain action as by being able to impel action. Each of the owners of an associated company possesses the ability to control its policies and actions by indirection. If control of an affiliated company is the only requisite to its inclusion in consolidated financial statements, as concluded in the previous chapter, then each of the owners of an associated company would be justified in adopting that treatment.
Summary

The supplementary statements presented by Monsanto Chemical Company represent a compromise between complete exclusion of associated companies from the consolidated statements and inclusion of those companies in their entirety. The Company appears to be unique in its adoption of the technique. The information presented portrays so much more to the reader of the report than prevalent methods that it is surprising that it has not been imitated. The accounting profession should be willing to experiment in the search for procedures which would provide the most useful accounting reports. If traditional concepts do not provide for the best possible solution to the problems brought on by a new set of circumstances, the concepts need to be re-examined. It would be easier to adopt new concepts and new principles than to change the circumstances.

It is clear that the present widespread use of the cost method of investment valuation is unsatisfactory. This has long been true in regard to unconsolidated subsidiary companies. The method fails to portray clearly the complete financial position and results of operations of the investing company. In view of the increased adoption and importance of investments in associated companies the same criticism can be applied to them. The example cited, American Viscose Corporation, graphically reveals the material importance that such investments may achieve and the inadequacy of the cost method to reflect their effects. A generally accepted, consistent technique should be developed to embody the effects of investments in associated companies in the financial statements.
The statement presentation technique which appears best adapted to accounting for investments in associated companies is that used by Monsanto Chemical Company for its supplementary statements. There is no more to be gained by presenting, in addition, consolidated statements which exclude the associated companies than would be gained by presenting statements for the parent company alone together with consolidated statements. That practice, as indicated in Chapter II, has practically been abandoned. The investor, for whom the corporate annual report is prepared, is interested in the total effectiveness of the company. His analysis of that effectiveness can best be made where the most complete disclosure of the assets employed on his behalf and the efficiency of their employment are clearly presented. The presentation of a second, less-complete set of statements would seldom aid that analysis and might often confuse it. The incorporation in the consolidated statements of but one-half of the amount represented by each account on the books of the associated company is contrary to the traditional technique of consolidation. However, the existence of associated companies is also contrary to the traditional concepts of corporate expansion. It is to be assumed that if one-half of the amount of each account balance of the associated company is appropriately included in the statements of one of the "parents," the remaining half would be included in the statements of the other. This exception to accepted techniques for consolidation would certainly be preferable to the present practice of excluding the accounts of associated companies from consolidated statements. Furthermore, it might well be more palatable than the duplications
which would result if each investor company followed the traditional technique of consolidating the associated company balances in total.

A satisfactory alternative reporting technique would be that of complete consolidation in the traditional sense. The criterion of control would appear to be met by the ownership of more than a minority interest in the company, although admittedly less than a majority interest. As proposed in the previous chapter, however, even absence of control would not impair the validity of the information incorporated in the statements. The major objection to traditional consolidation lies in the duplications which would result from each "parent" including the full amount of assets and liabilities, revenues and expenses of the associated company in its own statements. Such duplication would be the extreme opposite of and incompatible with the usual conservative accounting procedures. Further, its purpose and effects might well be misunderstood or misinterpreted by critics of business practice generally. For either or both reasons this alternative might be unacceptable.

A second alternative would be the adoption of the equity method for valuation of the "investment in associated companies" to be presented in the consolidated balance sheet. This would be preferable to the cost method but less satisfactory than either of the other two methods. The net effect of the investment is reflected by this method but the information furnished is insufficient for any but the most rudimentary financial analysis. It would, however, avoid the objections to each of the other two methods and therefore might be more readily adopted by the accounting profession. It is to be
hoped, though, that the choice of a method of reporting is decided upon the basis of the usefulness of the financial data presented rather than upon the avoidance of controversy.
CHAPTER VIII

SUMMARY AND CONCLUSIONS

The purpose of this study has been to examine critically the use of consolidated financial statements as a device for corporate financial reporting. The scope of the study was limited to whether or not such a reporting method is appropriate and the conditions which should exist to justify its use. The assumption was made that the mechanics of preparation of consolidated statements are generally acknowledged and applied. This study, therefore, excluded consideration of such techniques.

The Acceptability of Consolidated Statements

There is at present a more widespread ownership of equity securities of corporations than ever before. Separation of ownership and management of corporations is the rule. For that reason, the corporate annual report usually provides the only means of communication between the corporate management and owners. That report, therefore, should provide the clearest, most complete disclosure possible of the financial status and results of the company. Consistency of reporting, as between companies, should be one of the goals of the accounting profession.

Growth in size and scope of operations appears to be an unceasing tendency of a successful corporate enterprise. That growth
can take a variety of forms, one of which consists of the acquisition of ownership in affiliated companies. Where this relationship exists, a method of reporting which provides comparisons with other expansion forms is desirable. Consolidated financial statements are accepted as furnishing the best method of obtaining such comparisons.

Consolidated statements were originally considered as secondary or supplementary to the statements for the dominant company of a group. Examination of recent pronouncements of authoritative accounting groups and the prevailing practice in corporate annual reports indicates that such statements are no longer to be considered secondary. The consolidated statements are a primary form for reporting and usually the only statements presented in corporate annual reports.

Although most companies which have subsidiary companies present consolidated statements, not all of them do. Where such statements are used, some subsidiaries have been included while others have been excluded, with a lack of consistency between companies. This indicates that either the recognized policy for preparation of consolidated statements has not been generally accepted or that there has been uncertainty as to what that policy should be. It was concluded that the area of consolidation policy generally needed to be reappraised.

**Consolidation Policy**

Consolidation policy refers to the basis upon which the decision is made to include or exclude a subsidiary from consolidated statements. A body of theory on this point was developed during the earliest days of corporate expansion. The prevalent mode of expansion
at that time was internal growth coupled with absorption of competing business enterprises. The usual method of absorption was through statutory merger or consolidation of two or more separate legal entities into one. That method of expansion was reflected in the theory of consolidated statements.

The philosophy for consolidated statements required a closely administered, integrated group of companies operated in relatively close geographic proximity to each other. Transportation and communication facilities were such as to make any other arrangement unwieldy. Further, the eventual absorption of the affiliated companies was apparently contemplated. Thus, the consolidated statements were treated as a pro-forma presentation of what was expected to be legally accomplished in the near future. Certain restrictions upon consolidation were therefor proposed. The restrictions were designed to exclude from the statements an affiliated company which was not capable of being absorbed into a centrally managed, closely integrated, single corporate entity. The restrictions varied in detail as between proponents but could be classified into three categories. These provided that inclusion in the consolidated statements was not proper if (1) the subsidiary was involved in operations which were dissimilar to those of the rest of the group, (2) the subsidiary was located in a foreign country where the laws and protection of the United States would not prevail, or (3) there was an absence of or restriction on control of the subsidiary by the dominant company. Early in the history of the use of consolidated statements these restrictions did not materially affect the presentation of financial
status and results. Most affiliated companies did not fall into the
categories where the restrictions applied.

The nature of corporate expansion has changed since World
War II. There has been an emphasis upon diversification of product
line. There has been, also, an expansion of the services performed
by the company which manufactures the product. This expansion has
cut across the traditional lines of demarcation between production,
distribution, and financing. The results of diversification and
expansion of function, through acquisition or establishment of af­
filiated companies, have included the abolition of traditional
integrated operations. In addition, there has been a marked increase
in foreign investment by domestic corporations. Such investment has
been in large part through the medium of foreign affiliated companies.

Examples were cited of the consolidation policies currently
in use. Some corporations have followed a strict interpretation of
the conservative restrictions against inclusion of a non-homogeneous
or foreign subsidiary in consolidated statements. Other companies
have included all foreign subsidiaries but excluded non-homogeneous
ones. Still others have included some foreign subsidiaries but ex­
cluded other foreign subsidiaries. The material differences which
could have resulted from an alteration of consolidation policy were
discussed. It was concluded that there has been a decided lack of
consistency of treatment between companies. It appears that this
has been caused by the indefinite, negative nature of the accepted
standards for consolidated statements. The conclusion was reached
that those standards need to be re-defined in positive terms and in
view of current economic conditions.
Similarity or Integration of Operations

The ideal circumstances for the use of consolidated statements exist where the dominant company and its affiliates operate as though they were one, single-purpose, business unit. These circumstances would have prevailed when consolidated statements were first developed. At that time the tendency of corporate combinations was to group competing, or at least like, business units into a larger, more economic enterprise. The question of similarity of operations was not important. In the unlikely event that a dissimilar corporate affiliate had been acquired it was excluded from the consolidated statements. The exclusion of such a subsidiary was not apt to be material to the reported financial information.

As the production and distribution functions increased in complexity and profitability, vertically integrated corporations achieved increased importance. The dissimilarity of the individual corporate entities in the group made consolidated statements of questionable appropriateness. The issue was resolved by the acceptance of either similarity of operations or integration of operations of the consolidated group as requisites for the use of such statements. The generally accepted standard provided that a subsidiary whose operations were not similar to or integrated with the rest of the group should be excluded from the consolidated financial statements.

Conditions have since changed but the concept of homogeneity as a requisite to consolidation remains. Corporations have diversified their activities for a variety of reasons. Increased
made centralized administrative control inefficient. Similarity and integration of operations no longer apply to a major portion of the economic activities of a great number of corporate entities. There has been an unresolved conflict between the theory of consolidated statements and the practical circumstances to which the theory must be applied.

Corporate annual reports, applying a strict interpretation of this standard, in many cases fail to include a material part of the pertinent financial information in the financial statements. Some corporations have apparently used the restriction as an excuse to deliberately disguise their actual financial position and operating results. Others have observed the restriction but have attempted to implement by other means the information thus provided in the statements. The results have been a lack of consistency of treatment between companies and a failure of financial statements to present the clearest, most useful portrayal of financial information.

It was concluded that the accounting profession should recognize that circumstances have changed. Diversification and expansion outside traditional areas of endeavor are indicative of the prevailing trend of corporate expansion. The conclusion was reached that all subsidiaries should be included in the statements without regard to the homogeneity of their operations with the rest of the group. If that is not acceptable, a much less desirable alternative would be to use the equity or accrual method of valuation of the investment in the unconsolidated subsidiary company. The latter alternative would
provide more useful information than the cost method currently in use, but consolidation would still be most useful.

**Inclusion of Foreign Affiliates**

Isolationism, in business ventures as well as in other ways, was the prevalent philosophy until World War II. As a result, accounting for foreign investments by domestic corporations has been influenced by extreme conservatism. This has been reflected in the theoretical aspects of consolidated financial statements where foreign subsidiaries were involved.

Early in the history of the use of consolidated statements, foreign investments were relatively unimportant. Domestic opportunities for expansion of profitable operations were so great as to make the risk of most foreign ventures unattractive. There were, however, exceptions to the rule. For those exceptions, inclusion in the consolidated statements of a foreign subsidiary was considered appropriate. But, restrictions were proposed to eliminate overstatement of asset values and earnings. Those restrictions, broadly interpreted, could have been made applicable to practically any foreign subsidiary, wherever located. However, many corporations chose to include the accounts of foreign subsidiaries in their consolidated statements.

In 1939, the American Institute of Accountants issued a pronouncement so worded as to practically exclude all foreign subsidiaries from consolidated statements. Most domestic corporations did exclude foreign subsidiaries from their statements at the end of that year. The Institute has chosen to reaffirm the provisions of the
pronouncement since the end of the War, in 1953 and again in 1959. The result has been a great divergence in practice by corporations in recent years. Some corporations have chosen to follow the provisions to the letter and exclude all foreign subsidiaries from consolidated statements. At the other extreme, some corporations have resumed the inclusion of all foreign subsidiaries, wherever located. And, as a compromise apparently, still others include some foreign subsidiaries and exclude others. This has been done on the basis of relative safety of investment, apparently, but there is a great lack of consistency between companies as to the selection of safe and unsafe geographic areas.

Foreign investments have become increasingly more widespread and more important in recent years. Many factors have contributed to this trend. The proposed criteria for inclusion or exclusion of a foreign subsidiary in consolidated statements have been vague and negative in approach. Uncertainty as to the future has made the profession of accounting overly cautious, perhaps. The result has been, however, serious understatements of apparent asset values and apparent earnings by corporations which exclude foreign affiliates from their statements. Restrictions on investment and transfers of currency in foreign countries have not stopped investments. Corporations apparently have determined ways to circumvent the restrictions to an extent which makes the investment worth the risk involved.

The conclusion reached was that statements which exclude foreign subsidiaries do not fairly present the financial position and results of operations of a corporation. Because of this, foreign
subsidiary companies should be included in the consolidated statements. The danger of overstatement of asset values and earnings is present. However, there are generally recognized techniques for valuation which can be applied to the foreign subsidiary accounts in the consolidated statements. Less harm would normally be done by accidental overstatement of values than by the current understatements which result from exclusion of foreign subsidiaries from the consolidated statements.

**Control as a Requisite for Inclusion**

Control over an affiliated company has been consistently stipulated as an essential condition to the company's inclusion in consolidated statements. Originally, the control referred to was that inherent in the ownership of all or a large majority of the stock of another corporation. Such ownership carried with it the authority to designate the membership of the board of directors and, through the board, to dictate the policies and actions of the affiliated company. It further provided the means to use the assets of the affiliate to the greatest advantage to the dominant company.

The definition of control has been modified. Authorities on accounting theory have suggested that control could be achieved by means other than ownership. It would appear that a definitive description of control has not been possible. The Securities and Exchange Commission has adopted the position that only by majority ownership can sufficient evidence of control be provided to suit its requirements. No evidence was found, of the inclusion in consolidated
statements, of a minority-owned affiliated company, in corporate annual reports.

The reason for the insistence upon the existence of control as a condition for inclusion has not been made clear. The intimation, however, is that control of the affiliate provides the means for the majority owners to benefit at the expense of the minority. The information contained in the consolidated financial statements is exactly the same, item for item, except for the allocation of stockholders' equity between the majority interest and the minority interest. The lack of control, therefore, would not invalidate financial statements which included a minority-owned affiliated company.

Where more than 50% of the stock of the affiliated company is owned by the remainder of the companies in the group, sufficient control exists to justify consolidation. Therefore, it was concluded that all majority-owned affiliated companies should be included in the statements. Where the ownership is less than 50%, inclusion may be justified and proper but should not be mandatory. Some criterion is essential to determine the appropriateness of consolidation. Ownership of a substantial portion of the stock of the affiliated company appears to be the only valid requisite. Where a substantial ownership exists, but is less than 50%, and consolidation does not appear to be justified, the problem of adequate disclosure still exists. The cost method of investment valuation does not provide for a sufficiently clear and useful financial presentation. The
The equity method of valuation should be required for portraying the effects of the investment in a minority-owned affiliated company excluded from the consolidated statements.

The Enigma of the Associated Companies

The accounting for an interest in an associated company presents a special case. The existence of such companies has not been appropriately recognized in accounting literature. It would appear that the accounting profession hoped that by ignoring the problem it could be made to disappear.

Associated companies do not fit the traditional concept of corporate competition and monopolistic tendencies. They are established as a joint effort and for the mutual benefit of two otherwise separate corporations. Their existence is a contradiction of the previously accepted contention that domination and eventual absorption were the motives for the acquisition of ownership in an affiliated company. Such companies have been rapidly increasing in number and importance in recent years.

No provision for such companies has been made in the generally accepted reporting techniques used in the past. With but the one exception noted, the investment in associated companies has been reported at acquisition cost. The result has been failure to disclose adequately the effects of such an investment. The possible material results to be obtained were demonstrated by the presentation of a practical example. The same practical example was used to point out the failure of a generally accepted reporting method to disclose a major element of the financial data concerning the company.
The use of traditional reporting techniques was discussed in terms of their applicability to accounting for associated companies. The equity method of investment valuation would be appropriate for investments in associated companies. It would be preferable to the use of the cost method but would not provide as much information as might be desired. The existence of control was discussed as a basis for the use of either the equity method of accounting or consolidation of the associated companies. It was concluded that sufficient control would exist in the form of the ability to prevent action detrimental to the best interests of the investing company. It was further concluded that inclusion of an associated company in consolidated statements would be appropriate. The same treatment would be adopted by each of the two investing companies if consistent practice between companies is to be achieved. There might, therefore, be objections raised to the same amounts being duplicated in the statements of two separate corporate entities. This was recognized as the only valid objection to the use of normal consolidation techniques for associated companies.

The unusual technique used by one company to account for its interest in associated companies was discussed. That technique has consisted of reporting in the consolidated statements only their 50% share of each of the accounts on the books of the associated companies. This is contrary to recognized consolidation techniques but is preferable to inadequate disclosure. The statements would reflect the assets employed for the benefit of the stockholders and
the effectiveness of their employment. The conclusion reached was that this method presented the best approach to reporting investments in associated companies.
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An excellent reference work for a guide to the current attitude of the Securities and Exchange Commission as to accounting practices and presentations.

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AUTOBIOGRAPHY

I, Harry Curlis Lyle, was born in Hillsboro, Ohio, January 7, 1924. I received my secondary-school education in the public schools of Hillsboro, Ohio, and was graduated from there in 1942. I spent three years in the U. S. Army Air Forces during World War II, as an aircraft navigator. I entered The Ohio State University upon separation from service and received the Bachelor of Science in Business Administration degree in June of 1948. I was appointed as an Instructor in the Department of Accounting in October, 1949. I received the Master of Business Administration degree in March, 1950, from The Ohio State University. I continued as an Instructor in Accounting until 1952, when I left The Ohio State University to enter public accounting practice. I returned to the University as an Instructor in 1953 and have remained in that capacity to the present. During this period I have become a Certified Public Accountant and have completed the requirements for the degree Doctor of Philosophy.