

College of Business • Accounting and Finance

One Washington Square • San José, California 95192-0066 • 408/924-3460 • FAX 408/924-3419

December 18, 1995

Director of Research and Technical Activities
File Reference No. 154-D
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: 39
File Reference: 1082-154
Date Received: 12/27/95

To the Financial Accounting Standards Board:

I offer the following comments on the October 16, 1995 exposure draft on Consolidated Financial Statements: Policy and Procedures:

1. Provide an Illustration of the Statement of Changes in Stockholders' Equity in Paragraph 107.

In this paragraph, only the income statement format is displayed. I believe a compelling need exists to display as well the format for the statement of changes in stockholders' equity. Doing so serves to highlight the fact that the retained earnings account includes only amounts that accrue to the controlling interest (the parent company concept is effectively captured under the umbrella of the economic unit concept in this regard).

An example of a statement of changes in stockholders' equity under the economic unit concept is enclosed.

2. Discuss or Give Guidance on Events That Indicate Control Has Been Lost.

The exposure draft is noticeably mute on the difficult area of events that point toward nonconsolidation as a result of control having been lost. Other than the obvious example of *not* consolidating a subsidiary that has filed for bankruptcy (given in *ARB No. 51*), neither little guidance nor a discussion exists in the professional literature in this regard.

International Accounting Standard 27 requires all subsidiaries to be consolidated unless (1) control is likely to be temporary or (2) **the subsidiary operates under severe long-term restrictions that limit its ability to transfer funds to the parent.** Shouldn't similar wording be included in the U.S. standard?

If a foreign government has prohibited payment of dividends, the parent can no longer "do as it pleases with the subsidiary's assets" in all respects. Only partial control exists. A literal interpretation of the exposure draft might cause some to believe that consolidation is no longer possible because full control has been lost.

If giving specific guidance is not practical, then at least the problem should be acknowledged/discussed--with the caveat that judgment will be required in determining whether consolidation is still appropriate. My understanding of practice is that parent companies almost always consolidate subsidiaries for which they have "blocked funds" problems (as did Citicorp for 1992 and 1993 when the regulatory authorities placed operating restrictions on Citibank in 1992 such that it could not pay dividends until its financial condition improved).

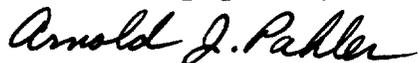
3. Correct the EPS Flaw That Exists for Reciprocal Holdings.

I believe a flaw exists in computing EPS when reciprocal holdings exist. Enclosed in a discussion of this flaw as set forth in the 5th edition (1994) of my advanced accounting text.

4. Overall Comment

Overall, the exposure draft is an extremely well crafted document. I fully support (1) the change to using *effective control* and (2) the change to the *economic unit concept*.

Very truly yours,



Arnold J. Pahler

**Consolidated Statement of
Changes in Stockholders' Equity**

	Non controlling Interest	Controlling Common + Stock	Interest Retained + Earnings	Total Stockholders' Equity
Balances, 1/1/X1...	\$20,000	\$200,000	\$117,000	\$337,000
+ Net income.....	8,000		134,000	142,000
- Dividends.....	(3,000)		(85,000)	(88,000)
Balances, 12/31/X1.	<u>\$25,000</u>	<u>\$200,000</u>	<u>\$166,000</u>	<u>\$391,000</u>

The key point here is that the amounts reported in the retained earnings column exclude any amounts accruing to the NCI.

	P Company's Investment in T Company	S Company's Investment in T Company	Total
Book value elements:			
Common stock	\$36,000 ^a	\$ 4,000	\$40,000
Retained earnings:			
Prior years	18,000 ^a	2,000	20,000
Current year:			
Earnings accruing to P & S	6,000	1,000	7,000
Earnings accruing to minority interest in T Co.	3,000		3,000
Dividends	(4,500)	(500)	(5,000)
Excess cost element:			
Land	6,000	3,500	9,500
	<u>\$64,500</u>	<u>\$10,000</u>	<u>\$74,500</u>
Total cost	\$45,000	\$10,000	\$55,000
Minority Interest in Net Assets of T Company	19,500		19,500
	<u>\$64,500</u>	<u>\$10,000</u>	<u>\$74,500</u>

^aBecause of the 10% horizontal investment, this amount is only 90% of the book value rather than 100%.

Review Points for Illustrations 12-4 and 12-5. Note the following:

1. For the percentage investment held in T Company, S Company's cost in excess of book value was greater than that of P Company. We assumed that (a) S Company made its investment in T Company after P Company made its investment in T Company and (b) the land appreciated in value during that interval.
2. The consolidation can also be performed using one consolidation worksheet in which companies S and T are simultaneously consolidated with P Company. This is the common procedure in practice; separate consolidations of each company are used here for instructional purposes.

Reciprocal Holdings

Reciprocal holdings occur when a subsidiary invests in its parent company's common stock. Two accounting questions are raised by such holdings:

1. How should the subsidiary account for the investment in the parent company?
2. How should the investment in the parent company be accounted for in consolidation?

Accounting by the Subsidiary

An investment by a subsidiary in its parent's common stock must be considered a long-term investment. Because such investments rarely, if ever, reach the 20% level, ownership in the parent's common stock is usually less than 20%. In this situation, the subsidiary must account for the investment

cost or
 at fair value, as prescribed by FASB *Statement No. 115*, "Accounting for Certain Investments in Debt and Equity Securities."

Remember that a subsidiary, as a separate legal entity, must follow generally accepted accounting principles without regard to the fact that it is a subsidiary. Many subsidiaries must issue separate financial statements pursuant to loan indenture agreements. When contingent consideration based on the subsidiary's postcombination sales or earnings amounts is a provision of the business combination agreement, separate audited financial statements are often required.

Accounting in Consolidation

The subsidiary's method of accounting for its investment in the parent when preparing consolidated financial statements is prescribed by *ARB No. 51* as follows:

Shares of the parent held by a subsidiary should not be treated as outstanding stock in the consolidated balance sheet.¹

If the parent had acquired its own shares, then the cost would be treated as a cost of treasury shares. But the parent directed the subsidiary to acquire the shares, which is usually the way such investments are made. If the subsidiary is wholly owned, this treatment makes sense. However, if the subsidiary is partially owned, the requirement to treat all of the shares it owns as not outstanding ignores the reality that the subsidiary's minority shareholders are indirectly shareholders of the parent. The requirement can cause a misleading earnings per share amount to be reported, as demonstrated later in the chapter.

This requirement of *ARB No. 51*, therefore, means that **in consolidation the cost of the investment in the parent's common stock is treated as a cost of treasury shares**. Accordingly, a reclassification must be made in the balance sheet section of the consolidation worksheet as follows:

**WORKSHEET
ENTRY ONLY**

Cost of Treasury Stock	XXX
Investment in Parent Company's Common Stock	XXX

When a subsidiary has lowered the carrying value of its investment in its parent through a valuation allowance, the offsetting charge to its stockholders' equity section (required for equity investments categorized as "available-for-sale securities" under *FASB Statement No. 115*) must be reclassified in consolidation as part of the total cost of the treasury shares. Until the subsidiary disposes of some or all of its investment in its parent, the balance of the cost of the treasury shares, as reported in the consolidated statements, remains unchanged.

When a subsidiary is wholly owned, consolidated net income is the sum of (1) the parent's earnings from its own operations, exclusive of earnings on its investment in the subsidiary and (2) the subsidiary's earnings from its own operations, exclusive of earnings on its investment in the parent.

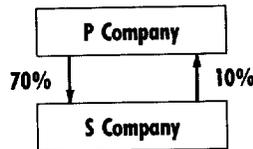
¹*Accounting Research Bulletin No. 51*, "Consolidated Financial Statements" (New York: American Institute of Certified Public Accountants, 1959), par. 13.

These situations present no accounting issues in preparing consolidated statements.

When a subsidiary is partially owned, the accounting issue is how to report the combined earnings for financial reporting purposes **in view of the fact that the subsidiary's minority shareholders are indirectly shareholders of the parent**. ARB No. 51 does not specify the procedures for these situations. Two schools of thought explain how the combined earnings should be reported—one advocating the **treasury stock method** and the other advocating the **traditional allocation method**. Each of these methods is best discussed using an example. Assume the following information:

	P Company	S Company
Number of common shares outstanding	100,000	20,000
Ownership interest in the other:		
Percentage	70%	10%
Number of shares	14,000	10,000
Net income for the year (from own separate operations, exclusive of earnings on investments in the other)	\$1,000,000	\$500,000

The affiliation diagram is as follows:



The Treasury Stock Method

The **treasury stock method** comes under the parent company concept, which is discussed in Chapter 5. Recall that under the parent company concept, the parent is the reporting entity. The consolidation process is merely the substitution of the subsidiary's assets and liabilities for the parent's Investment in Subsidiary account. From this perspective, consolidated net income should be the sum of (1) the parent's earnings from its own separate operations and (2) the parent's share of the subsidiary's earnings from its own separate operations.

From the above information, **consolidated net income under this method is \$1,350,000** [$\$1,000,000 + (70\% \times \$500,000)$]. Thus the minority interest deduction is based solely on the percentage of minority interest ownership in the subsidiary's earnings from its own separate operations, exclusive of earnings on its investment in the parent. Thus the minority interest deduction would be \$150,000 (30% of \$500,000).

The consolidated net income, therefore, is the amount by which the parent's retained earnings would increase if the subsidiary distributed as dividends all of its earnings from its own separate operations, exclusive of its earnings on its investment in the parent. Dividend distributions to the parent's stockholders are ignored in calculating the amount of this increase.

Whether the parent uses the equity method or the cost method to account for its investment in the subsidiary is irrelevant.

When the parent accounts for its investment in the subsidiary under the equity method of accounting, it merely applies its ownership percentage in the subsidiary to the subsidiary's earnings from its own separate operations, not including the subsidiary's earnings on its investment in the parent. In the example, this would be \$350,000 (70% of \$500,000). As a result, the parent's \$1,350,000 recorded net income equals the \$1,350,000 consolidated net income.

Earnings per Share: Is It Meaningful? The amount of earnings per share on a consolidated basis (assuming no other dilutive securities) is computed by dividing the consolidated net income of \$1,350,000 by the 90,000 shares deemed outstanding (100,000 shares issued – 10,000 shares held by the subsidiary treated as not outstanding). This computation gives \$15 per share. However, treating all 10,000 shares of the parent's stock held by the subsidiary as not outstanding results in a meaningless earnings per share amount. If the parent distributed as dividends all of its \$1,350,000 consolidated net income, this amount would not be distributed solely to the holders of the 90,000 shares. Because 10,000 shares of the parent's stock are held by the subsidiary and because the subsidiary is only 70% owned by the parent, the subsidiary's minority shareholders are effectively indirect shareholders of the parent to the extent of 3,000 shares (30% of 10,000). Assume that the subsidiary was liquidated immediately after it distributed as dividends its net income from its own separate operations. The 10,000 shares held as an investment in the parent would be distributed to the subsidiary's shareholders: 7,000 to the parent and 3,000 to the minority shareholders. Thus the parent's consolidated net income of \$1,350,000 would be distributed to holders of 93,000 shares, not 90,000 shares. Dividing \$1,350,000 by 93,000 gives \$14.52 per share. In terms of dollars, the holders of the 90,000 shares would receive \$1,306,452 ($90,000 \div 93,000$) of the consolidated net income of \$1,350,000. The minority interest shareholders would receive \$43,548 ($3,000 \div 93,000$) of the \$1,350,000 consolidated net income. The \$14.52 earnings per share amount is therefore more meaningful.

The Traditional Allocation Method

The **traditional allocation method** comes under the economic unit concept, which is discussed in Chapter 5. Recall that under the economic unit concept, a "new reporting entity" is deemed to exist as a result of consolidation. This new reporting entity has two classes of shareholders:

1. The controlling interests (in the example, holders of 90,000 shares of the parent's outstanding common stock).
2. The subsidiary's minority shareholders (who indirectly own 3,000 shares of the parent's outstanding common stock in the example).

From this perspective, the combined earnings of the parent and the subsidiary should appear in the consolidated income statement so that the amount that accrues to each class of shareholders is shown. As demonstrated in the discussion of the treasury stock method, the holders of the

90,000 shares are entitled to \$1,306,452 of the combined earnings of \$1,500,000 (\$1,000,000 + \$500,000), and the minority shareholders are entitled to \$193,548. The amount that accrues to the minority shareholders can be thought of as comprising two amounts, as follows:

1. The minority shareholders' interest in the subsidiary's earnings from its own separate operations, exclusive of earnings from its investment in the parent (30% of \$500,000)	\$150,000
2. The minority shareholders' interest in:	
a. The parent's earnings from its separate operations	\$1,000,000
b. The parent's share of the subsidiary's earnings of \$500,000 from its own separate operations (70% of \$500,000)	350,000
	<u>\$1,350,000</u>

As shown in the discussion of the treasury stock method, the minority interest in these amounts is in the ratio of 3,000 shares to 93,000 shares (3,000 ÷ 93,000) × \$1,350,000 =	43,548
Portion of combined earnings that accrues to the minority shareholders	<u>\$193,548</u>

Recall from Chapter 5 that under the economic unit concept, the combined earnings of the parent and the subsidiary are presented in the consolidated income statement as follows:

Earnings accruing to controlling interests	\$1,306,452
Earnings accruing to minority interests	193,548
Consolidated Net Income	<u>\$1,500,000</u>

Some accountants advocate an alternative presentation that deducts the amount accruing to the minority interests from the combined earnings of \$1,500,000 to arrive at a consolidated net income of \$1,306,452. This presentation is inconsistent with the underlying premise of the traditional allocation method, in which the parent is not viewed as the reporting entity.

Reporting the combined earnings using either of these manners of presentation is obviously inconsistent with the equity method of accounting and the amount reported as consolidated net income. In a strict application of the equity method, the parent would record \$350,000 as its share of the subsidiary's earnings (70% of \$500,000). Thus the parent's net income under the equity method would be \$1,350,000, which is not reported using either of the above methods of presenting the combined earnings.

Earnings per Share: On the Mark! The amount of earnings per share on a consolidated basis (assuming no other dilutive securities) is computed by dividing the \$1,306,452 earnings that accrue to the controlling interests by 90,000 shares deemed outstanding (100,000 shares issued – 10,000 shares held by the subsidiary treated as not outstanding). This computation gives \$14.52 per share, which is a meaningful amount to the holders of the 90,000 shares. (The same earnings per share amount

was calculated under the treasury stock approach using 93,000 as the denominator.)

Using Simultaneous Equations. Mathematically, the amount of the combined earnings that accrues to each class of shareholders is usually determined under this approach using simultaneous equations. In Illustration 12-6, the data from the example in this section are used with simultaneous equations to arrive at these amounts.

Which Method Is Correct?

Whether to use the treasury stock method or the traditional allocation method depends on whether the parent company concept or the economic unit concept produces the more meaningful form of reported combined earnings. This purely subjective evaluation is based on whether or not the reporting entity is transformed into a new reporting entity by the consolidation process. The treasury stock method is widely practiced, whereas the

ILLUSTRATION 12-6

Application of Simultaneous Equations to Traditional Allocation Method

Let *P* equal P Company's net income from its own separate operations plus its share of S Company's net income that would accrue to it on S Company's liquidation. Let *S* equal S Company's net income from its own separate operations plus its share of P Company's net income that would accrue to it on P Company's liquidation. Thus

$$P = \$1,000,000 + (.70 \times S)$$

$$S = \$500,000 + (.10 \times P)$$

Substituting for *P*:

$$S = \$500,000 + .10(\$1,000,000 + .70 \times S)$$

$$S = \$500,000 + \$100,000 + .07S$$

$$.93S = \$600,000$$

$$S = \$645,161$$

S Company's minority shareholders would be entitled to \$193,548 (30% of \$645,161). Subtracting \$193,548 from the combined earnings of \$1,500,000 gives earnings of \$1,306,452, which accrue to the controlling interests.

Alternatively, the earnings that accrue to the controlling interests can be computed by solving the equation for *P* by substituting for *S* as follows:

$$P = \$1,000,000 + .70(\$500,000 + .10 \times P)$$

$$P = \$1,000,000 + \$350,000 + .07P$$

$$.93P = \$1,350,000$$

$$P = \$1,451,613$$

Because P Company's existing shareholders (other than S Company) own 90% of its outstanding common stock, they would be entitled to \$1,306,452 (90% of \$1,451,613) in the event of a double liquidation.

s/B
.93S

s/B
.93P