PRINCIPLES AND PROBLEMS IN CONSOLIDATION

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I Introduction

1 From olden days the universities of Western Europe have had five faculties, viz. theology, philosophy and arts, mathematics and physics, law and medicine. In the Netherlands a sixth faculty, that of economics, was founded about 1920 and in 1950 a seventh faculty was added, viz. politicology.
2 The faculty of economics studies productive activities in general from the economic point of view. In this it is useful to differentiate between the problems which arise within industrial and business enterprises (the centres of production), and the problems of society. The first is called business or industrial economics, the second general or social economics (macro and micro economics).
3 In the Netherlands the development of business economics has been of great importance to the theory and practice of accountancy.
4 It is important to understand that this development has been independent of developments in civil-law or tax-law. In many international studies on problems of business-economics, civil-law and tax-law tend to be over-stressed.
5 The problems concerning consolidation will be reviewed from the business-economical point of view. Civil-law or tax-law aspects will only be brought into the picture as incidental considerations. The opinions which are given in this paper have been taken from various Dutch publications.
6 In this paper Consolidation means the joining of accounts (both balance sheet and profit and loss account) of separate legal entities. These entities are to be distinguished as mothers (holding-companies), daughters (subsidiaries), grand-daughters (sub-subsidiaries) etc. A mother company has *de jure* and *de facto* power of control, often on the basis of ownership of shares, but it can be also on the base of agreement (foundation, trustee).
7 In May 1971 a new companies act giving detailed regulations on the annual accounts of business enterprises came into force in Holland. This law requires that the annual financial statements give a proper insight into the size of the shareholders' equity (including share capital, retained earnings and reserves) and the profit or loss attained. The annual accounts must provide sufficient information for a sound judgment to be formed on the financial position and results of the enterprise and its solvency and liquidity.
8 The law requires this insight both for mother companies and their subsidiaries. According to the act any company in which a financial interest of at least 25% of the share capital is held is always considered a subsidiary. Publication is required of either separate accounts of mother and daughter companies (the accounts of more than one daughter company may be combined) or consolidated accounts of the group.

II Objectives of consolidated accounts

9 The prime objective of consolidated accounts is to provide information on the economic position of a company irrespective of the legal structure of that company. Information is a necessity for communication (internally and externally) in society (Robinson Crusoe being an exception).

10 Internal communication carries the information supplied by the accounting section to the different levels of management, including the board of directors (Management information). The managers need this information to operate and to direct the organization in the long and the short run; therefore the information must be up-to-date and complete, but not too extensive, in order not to divert attention from the main headings.

11 External communication carries the information provided to existing shareholders, creditors, employees, banks, etc. and to those who might be potential future shareholders, creditors, etc.

12 The promotion of internal and external communication requires that correct and complete information is supplied as an adequate base for the decisions to be made. The message implied in the information should be clear and understandable to the receivers. The information has to give a true and fair picture of the business-economical reality.

13 The auditor's function of reporting in the annual accounts is the same for consolidated as for non-consolidated accounts. Consolidation does not enlarge or diminish his responsibility for the correctness of the overall position.

14 The non-consolidated accounts of a mother company should present the same profit and the same shareholders' equity (share capital, retained earnings and reserves) as the consolidated accounts. If the information supplied in these accounts differs, one of the two is misleading and does not give the required proper insight. The reporting auditor cannot certify both different accounts.

15 Consolidated accounts should give clear information on the following aspects of the business enterprise as a whole:

solvency - liquidity - profitability.

16 Consolidated accounts are arrived at by ignoring the boundaries of separate legal entities which have a legal background, but not a business-economical one. In the definition (para. 6) the power of control has been taken as a criterion so that from the point of view of business-economics, subsidiaries are no more than departments and should be treated as such. The reporting auditor should report on the reality as seen in the business-economical way which may differ from the tax way.

17 The problem of consolidation is less a technical problem of accountancy than one of organization, viz. of administrative organization. The managers of a group can only take their decisions if they have sufficient information at their disposal. The so-called consolidation problems are mainly problems of management. These occur not only once a year, when the annual accounts are drawn up, but continuously at any moment when the information may be needed for taking decisions. Because of his profes-

sional training and practical experience the external accountant can play an important role as an adviser.

18 In general it may be said that one set of consolidated accounts per annum is not sufficient. Monthly or quarterly accounts will be necessary and the accounting schedule will have to be adapted in order to create potential for continuous consolidation.

19 Non-consolidated accounts give incomplete and consequently inadequate information about liquidity, because in the balance sheet of the mother company the items subsidiaries and receivables from subsidiaries only show the balance of long-term and short-term liabilities together with current and fixed assets of the subsidiaries.

20 It is essential that the same accounting principles are used for the separate departments of one enterprise, as a misleading picture would result if accounting principles differed from one department to another without any business-economic justification. The same goes for separate legal entities in one group.

III Consideration of general problems

(i) *Solvency*

21 Solvency in this context means the ability of an enterprise to meet all its debts in the long term. This has also a legal impact.

22 When the liabilities of subsidiaries are secured by guarantees or collateral securities of the parent company there is no question of a separate problem. The consolidated accounts give ample information.

23 When this security does not exist the creditors of the subsidiary certainly have an interest in information about the assets and the liabilities of that company; but they should realize that the parent company has the power to reduce the liquidity and the solvency of the subsidiary by requiring payment of dividends or repayments of capital.

(ii) *Liquidity*

24 Liquidity in this context means the ability of an enterprise to meet its short term debts on the due dates - shorter than one year.

25 Contrary to non-consolidated accounts, consolidated accounts show the aggregate totals in one currency of receivables, cash at hand and in banks and short term liabilities. If the various underlying currencies are subject to restrictions on transfer, some problems arise.

26 It may be noted that the actual and perhaps incidental exchange rate on the date of the balance sheet or around that date, gives an insufficient base for conversion. This exchange rate can be influenced by many casual and incidental buyings or sellings; besides, central banks can retard or speed up the adaptation of the official exchange rate to the real economic rate. It would appear to be more in accordance with economic reality to take the "purchasing power rates" and in this respect I refer to developments along the lines of Gustav Cassel's theories.

27 The official transfer rate should only be taken for that part of the profit which actually has to be transferred. Careful attention should be paid to the substantial differences between the ascertainment of the profit in total and the appropriation of profit to be paid to shareholders.
28 It should be realized that in the relation between parent and daughter company there is only one balance of receivables and liabilities. A good central management committee can try, if necessary, to reduce this balance to nil. I do agree with the need for supplementary information about foreign liquidities if the amounts involved are material.

(iii) *Profitability*
29 The term profitability expresses the relationship between profit made by the group and the total sum of capital, retained earnings and reserves (gross capital or shareholders' equity). It has nothing to do with the destination of profit.
30 The group profit can only be presented fairly if there is uniformity of accounting principles within the group.
31 Business-economic profit consists of results on transactions only, so that additions to gross capital resulting from revaluations of assets are not included. This business-economic profit should be related to a specific information period so that no past or future profits may be included. This condition rules out the influence of hidden reserves on the business results.
32 A relatively simple way to attain this object is always to value the subsidiaries in the balance sheet of the mother company against the networth of the daughter as determined by the application of the uniform accounting principles of the group. The result of this method is that annual changes in gross capital and the yearly profit are clearly distinguished in the non-consolidated balance sheet of the mother company. The non-consolidated as well as the consolidated statements will then show the same gross capital and the same profit (para. 14).
33 Differences in accounting dates do not give rise to a real problem. Although the formal financial years may differ, interim accounts for specific periods will be necessary for the information of the central management of the group. They will need these for their policy and decision-making. The interim accounts can be used for consolidation purposes.
34 The condition of applying uniform accounting principles can mean that for some daughters it may be necessary to draw up more than one set of accounts, viz. accounts which comply with the rules of the local government and accounts based upon the accounting principles of the group.
35 In this context mention may be made of the usual difference in Holland between business-economic accounts and accounts compiled for tax purposes. The origin of these differences lies with the fact that the accounting principles resulting from the business-economic approach are different to those prescribed by fiscal law.
36 A firm attitude should be adopted against the practice of joining annual accounts drawn up on different accounting principles, as this is an abuse. Consolidated accounts must have business-economic significance and should

not be an algebraic sum of pears and apples since this does not supply any real information at all (para. 20).

37 The plea for recognition of the individual characteristics of subsidiaries does not attach sufficient value to the requirements of the general management of the group which needs information on a uniform basis. The information requirements of the local management can be met by more detailed information which can be supplied as supplementary information. But this should be done on the basis of the same accounting principles.

38 The purpose of uniform accounting instructions is to give the holding-company the information necessary for proper preparation of consolidated accounts. The real target should be to give the central-top-management the information necessary to make decisions. In this manner the accounts become a real tool of management.

39 From the moment the profits as determined for tax purposes show a difference from the business-economic profits given in the consolidated accounts, a new problem arises, viz. the problem of deferred taxation. The difference in profit calculation may lead to a long term tax liability or receivable. This problem grows when it concerns a group with subsidiaries in various countries with different tax regulations. Consequently, for different subsidiaries in different countries special alterations in the tax provisions are necessary.

40 In the consolidated profit and loss account the business-economic profit of the group has to be shown and after that, the tax payable is deducted. This tax may have to be paid in the short term (tax liability) or in the long term (tax provision).

41 Another point to consider is the following: Is the information given to external interested parties sufficient if they are not informed on the composition of the profit made in the different countries where the subsidiaries are situated? This question remains unchanged even if the possible weakness of a foreign currency at the time of valuation has been taken into consideration while setting the conversion rate of exchange.

42 Another problem is connected with the fact that the ultimate profit can be a balance of large profits in some subsidiaries and big losses in others. This problem is not a specific problem of consolidation for even without formal borderlines, the profitability per department can differ enormously. If necessary, the analysis can be given in the notes to the consolidated accounts and an auditor, when reporting on annual accounts, will always question whether sufficient information has been given. He will have to study the annual accounts carefully from this particular angle.

43 Every risk cannot be appraised in terms of money. In this connection there may be political risks when there are investments in foreign countries. These political risks should be mentioned and brought to the attention in a special note.

(iv) *Inter-company profits*

44 Inter-company profits are a consequence of integration within the business column. If one or more markets are eliminated for an enterprise on

ceasing to be independent and entering a group with a central-top-management, the problem of inter-company profits arises. Sales within a group normally yield no transaction profits since such profits are supposed to result from transactions with third parties outside the group.
45 Generally it is prudent not to show profit within a group before a sale to such a third party has taken place, as it is very difficult to appraise the economic value of the goods in question. However, if there are markets with competitive prices there is no difficulty as it is then possible to see inter-company profits as real profits. In International Paper 52 an example is given of delivery of capital equipment by a subsidiary to a mother company. This example only treats one specific case; the main question is whether there is a market value which can be used to ascertain profit.
46 Further attention should be given to the definition of inter-company profit. Profit is the difference between selling price and cost. Selling price has already been discussed, but several points require attention in relation to cost.
47 Given standard unit costs the difference between selling prices and costs - eliminating opening and closing stocks - arises from four component parts:
a. differences in prices
b. differences in efficiency
c. differences in utilization level of machinery
d. profits on transactions
48 Cost price means the integral unit costs; this is the normative pre-calculated cost, including the full overhead and interest on gross capital invested. Specific parts of unit costs and differences between unit costs and returns can be traced to specific departments or subsidiaries. Differences in efficiency and intensity of utilization will always form part of profit or loss of subsidiaries. Differences in prices may be profits or a consequence of revaluation and as such no profit. As long as the cost price is no higher than the market value, interest on gross capital and full overhead are to be included in the valuation on the balance sheet and consequently are credited to the profit and loss account.
49 In conclusion it may be said that inter-company profits should be defined from case to case and that it is too far fetched to say that these profits should be eliminated in every case.

IV Consideration of specific problems

(i) *Companies to be consolidated*
50 According to the definition given and in accordance with the business-economic point of view, all companies over which the central-top-management *de facto* exercises power should be consolidated. This power makes it possible to enforce the administrative instructions (uniform accounting principles, uniform items in accounts) and to get in time the information necessary to make decisions.

51 The consolidated accounts are the means by which top management renders account of its policy.
52 The limitation of the consolidation to only those companies over which the mother company has complete or partial possession of the shares does not seem useful. Doing so would exclude various other legal forms, such as foundations, trusts, etc. from consolidation and consequently also from the rendering of the account of management.
53 The exclusion of subsidiaries which form part of completely different branches of industry or commerce from consolidation will be sporadic. Banks are indeed an example, because the significance of the item "creditors" used by banks is totally different from the item when used by other companies, although the difference can be made clear by means of a good presentation.
54 Subsidiaries in foreign countries should only be excluded from consolidation if, for instance, war causes figures to be unavailable.
55 It will be clear that I fully agree that consolidated accounts should give sufficient information, based on economic reality.

(ii) *Frequency, extent and speed of information*
56 Problems of consolidation are problems of information and communication. For internal communication, the need is for information at the top management level of the group on the basis of a business-economic approach. The frequency may differ from group to group, but there will always be a necessity for information more than once a year.
57 The consolidation problem requires continuous attention and should be solved with speed every month or quarter of a year. The lower the level of management, the more detailed the information will have to be, diminishing as the level of management rises; the extent of external communication being the smallest (paragraph 37).

(iii) *Differences in accounting dates*
58 Given a good organization of the accounting section, differences in accounting dates cannot form a problem. It is clear that extra work has to be done if the group has a different financial year to the subsidiaries. The impression that algebraic balance sheets drawn up on different dates can be added up, must be dismissed. To prevent the elimination of a subsidiary because of insufficient accounting organization, I have stressed the need for good communication. Consolidation is definitely not a problem of mathematics or bookkeeping; it is a real problem of organization and business-economics, especially of administrative organization.

(iv) *Acquisition of subsidiary companies*
59 At the acquisition of new daughter companies some problems of valuation arise. Usually these subsidiaries have had other accounting

principles before the acquisition and application of group accounting principles can give rise to differences on the following points:
a. valuation of fixed assets
b. valuation of current assets
c. presentation of hidden reserves
60 By applying the accounting principles of the group, a revised balance sheet of the subsidiary at the moment of acquisition will result. This balance sheet forms the basis for the valuation of the subsidiary in the non-consolidated balance sheet of the mother company. It is the first step in simplifying the consolidation in the future.
61 The differences from applying other accounting principles should be ear-marked in the subsidiary as revaluation differences and not as profit. By doing so only business-economic profits based on the accounting principles of the group will arise in the future.
62 After correction of the balance sheet of the subsidiary according to the accounting principles of the group, a difference may arise between the corrected gross capital of the subsidiary and the purchase price of the subsidiary.
63 This price will be paid in money or in shares of the mother. Shares can consist of those which are quoted on a stock exchange or non-quoted stock, either of which have to be valued in money terms. The quotation on the stock exchange, to be taken from the last quotation on the day of acquisition or an average over a period before the take-over, may be taken as the basis for valuation. For non-quoted stock an appraisal of the value is necessary but it goes beyond the object of this paper to discuss the methods of valuation.
64 If newly-issued shares in the mother company are handed over as payment at a higher value than par a paid-in surplus will result, which will be recorded as a part of the shareholders' equity.
65 We can now compare the value of the subsidiary after revaluation with the amount paid for the acquisition. Differences between these two can have two causes:
a. the subsidiary has an over/under profitability
b. the parties were not equally matched in economic power.
66 In case of over/under profitability a positive or negative amount for goodwill will arise which should be written off against future results. This future should not extend over too long a period because the influence of new top management will be noticeable before long.
67 Differences resulting from economic inequality of the two parties cannot be seen as a part of the profit, but should be charged or credited to reserves.
68 The difference in valuation of shares for purchase accounting or pooling of interest accounting for subsidiaries, is not nery convincing. Seen from the standpoint of central-top-management and also from the business-economic point of view, there is no reason to value newly-issued shares at par if the real value is higher.
69 In order to ascertain that hidden reserves at the beginning have no

influence on future annual results, a close examination of the situation at the start is necessary.

70 The problem with regard to pre-acquisition profits of subsidiaries has to be separated into two parts. Retained profits attained before the date of acquisition are part of the gross capital of the subsidiary and should be treated as such. Profits made after the date of acquisition can be treated as real profits provided the accounting principles of the group have been applied.

V Conclusion

71 I am very happy with the statement at the end of the international paper. In particular, the following paragraph has my full endorsement:

"True accounting principles ought not to vary from one territory to another. Best accounting practice should always aim to be in advance of legal minima".

The auditor, who is working in the international field, should always try to give support to his aim.

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