

# American Institute of Accountants

270 MADISON AVENUE, NEW YORK 16, N. Y.  
April 2, 1951

To the Members of the  
Committee on Accounting Procedure

Gentlemen:

Re: Stock Dividends and Earnings  
of Subsidiaries

Under date of March 23rd you were sent a letter enclosing a copy of the agenda for the next meeting of the committee. In that letter it was stated that we would prepare another draft of a possible bulletin dealing with "Accounting for Stock Dividends and Earnings of Subsidiaries by a Parent Company" (Item VI), to replace the draft of 3/22/51, and suggestions were invited.

While very little time has elapsed since then, so that we have been able to hear from only a few members of the committee, my travel schedule during the next two weeks is such that it seemed best to prepare a new draft without waiting for further comments.

Enclosed is a copy (Research Draft 4/2/51) of such a revised draft, in which we have attempted to give reasons supporting the conclusions reached. It will be used as the basis for discussions of this subject at the meeting.

Very truly yours,

Carman G. Blough  
Director of Research

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enc.

ACCOUNTING FOR STOCK DIVIDENDS AND EARNINGS  
OF SUBSIDIARIES BY A PARENT COMPANY

1. Accounting Research Bulletin No 11, page 104, states that:

“It is recognized that this rule, under which the stockholder has no income until there is a distribution, division, or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries. . . . A discussion of this problem is, however, also deemed to be beyond the scope of this bulletin.
2. In some quarters this statement has been interpreted to permit a parent company to take up as income a stock dividend declared by a subsidiary. The present committee does not agree with that interpretation. It believes that the committee which issued Accounting Research Bulletin No. 11 made the above-quoted statement because it did not wish to deal at that time with the accounting by a parent for income of a subsidiary company. This bulletin has been prepared to clarify Bulletin No. 11 in this respect and to state the present committee's views on the question.
3. Accounting Research Bulletin No. 11 states as a general principle that “an ordinary stock dividend is not income from the corporation to the recipient in any amount.” That conclusion was based upon the view that the problem of determining the stockholder’s income is distinct from the problem of income determination by the corporation itself; that the corporation should be considered as a separate entity without regard to the equity of the respective stockholders in its income. Under that concept, there can be no income to the stockholder until there is a distribution, division, or severance of corporate assets in the form of cash or its equivalent.

4. The present committee believes that concept is still valid. An ordinary stock dividend, as defined in Bulletin No. 11, meets none of the foregoing conditions. It merely changes the evidence of ownership. Actual ownership is vested in the same stockholders to the same degree. Net corporate assets before and after the stock dividend remain the same. The stockholders have not realized a gain. As a practical matter, the earnings are often invested in the business and are not, therefore, available to the stockholders. Nothing is changed except for the evidence of ownership and the manner in stating the corporation's equity accounts. The term "stock dividend" is an unfortunate designation. In nature, an ordinary stock dividend is a type of stock split-up. There appears to be no more justification for recognizing income to the recipient of an ordinary stock dividend than there is to the recipient of a stock split-up.

5. In view of these characteristics, there appears to be no substantial reason arising from the parent-subsidary relationship for treating ordinary stock dividends differently when the recipient is the parent than in the ordinary case of a corporation owned by many stockholders. All arguments supporting the general principle apply with equal force to the special case.

6. In cases where subsidiaries are regarded as operating branches, it may be argued that earnings of the subsidiaries are, in effect, earnings of the parent and that the separate reports of parent companies are misleading if they do not include those earnings. If this is so, it seems clear that the time at which the parent has gained anything is when the earnings accrue to the subsidiaries. Accordingly, if the parent is to recognize the earnings and losses of such subsidiaries, they should be recognized as they accrue to the subsidiaries. Neither on this basis, which would recognize all the earnings and losses of a subsidiary, nor on the "separate entity" theory, which recognizes no income except through a distribution, division or severance of corporate assets, would recognition be given to ordinary stock dividends. Recognition of

ordinary stock dividends as income to the corporate recipient could only be by arbitrary action in violation of both of these basic theories of income accrual. Accordingly, the committee is of the opinion that ordinary stock dividends of subsidiaries should not be taken up either in income or retained earnings (earned surplus), regardless of whether the subsidiaries are wholly owned or not.

7. The principle of accrual of all earnings and losses of subsidiaries on the books of the parent has had some support and has been followed by some corporations. The committee believes this practice has significant disadvantages. It creates confusion between separate and consolidated statements. It shows neither the sales and costs that are related to the combined income nor the significant relationship between income and the various assets and liabilities which produce it. Thus, combining the profits and losses of subsidiary companies with those of the parent company, on parent company financial statements, produces a hybrid set of accounts neither wholly separate as to entities nor wholly consolidated, and may lead to misconceptions as to the true earnings of the parent company. Since the medium of the consolidated financial statements has been developed to portray the combined results of operations and the combined financial position of a parent and its subsidiaries, without disturbing the accounts of the separate legal entities, there appears to be no real need or reason for confusing the income of the parent company with that of its subsidiaries. The committee therefore believes that, except for the recognition of a permanent impairment of its investment, the practice of accruing earnings or losses of subsidiaries on the books of the parent company should be discouraged.