

# **An Uncommon Source of Financing May Precipitate New Disclosure Requirements**

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## **Abstract**

Large and small holding companies have been raising large amounts of cash by selling off portions of subsidiaries to an eager investing public, according to recent reports in the financial media. Reintroducing a technique made popular in the late 1960's known as "carving out" subsidiaries, corporations are tapping an uncommon source of financing—their equity in wholly-owned subsidiaries.

## **Parent Company Incentives**

By liquidating a portion of their interest in high-performing businesses, parent companies have benefited by diluting risk and increasing the value of their shares without sacrificing ultimate control of the sub-unit. One SEC official described the appeal of "carving out" subsidiaries as a "phenomenon of the bull market." The lure is particularly strong when the subsidiary is operating in one of the popular industries on Wall Street or is experiencing impressive growth. In such cases, the parent can command a significant premium per share over its investment, and therefore an attractive return. When deciding which subsidiary to sell, the natural choice is one operating in an industry whose stock is selling at high price-earnings ratios. Recently, subsidiaries engaged in computer systems, health services, financial services, communications, or wholesale and retail sales have been the most likely choice for partial spinoffs. These transactions offer several advantages to parent companies. W.R. Grace & Co., in its 1984 offering of 3,000,000 shares of El Torito Restaurants, Inc., expressed the following objectives:

1. Financing the parent's capital expenditure program,
2. Establishing an outlet for the subsidiary's stock to tie in with incentive compensation plans

3. Demonstrating to investors the quality of the parent's holdings.

The technical aspects of achieving these goals touches a sensitive nerve among accountants. A subsidiary issuing stock for cash or an acquisition records the current value of what was acquired as an asset on its balance sheet. The controversy surrounds recognizing the increase of the parent's investment account over the lost percentage of ownership. Some accountants believe the increase relates to a revaluation of ownership and should be accounted for in the parent's paid-in capital account. In contrast, the SEC permits the increase to be classified a non-taxable, non-operating gain on the income statement. As a bonus, parent companies have increased the carrying value of their investments through "carve-out" benefits from enhanced earnings.

As further incentive to the parent, there are additional subordinated benefits. For "high-tech" subsidiaries subject to substantial risk, the parent can reduce its risk of loss immediately through a partial spinoff. But because most "carve outs" don't involve loss of a controlling interest, the parent can still be assured of maintaining decision-making authority. Retaining control allows flexibility to buy back the subsidiary at favorable prices should the subsidiary's market value decline mark-

edly below the offer price. The Wall Street Journal's informal survey of "carve outs" from the late 1960's to the early 1970's pointed out examples of investors who sold out the parent often at a fraction of the initial offer price.

Often a subsidiary will participate in the offer with the parent. By selling its own shares, the subsidiary can share in the success of the offering. Depending on the size of the offer, the proceeds could be used to repay borrowing from the parent or others, pay a dividend to the parent, augment working capital, or expand its operations. Following such combined offerings, the subsidiary may very well have gone a long way toward improving the quality of its balance sheet and its credit worthiness.

### **Promoting Full and Fair Disclosure**

Apparently through the registration process, the Securities and Exchange Commission noticed an increase in the volume of sales of "carved out" subsidiaries and identified a problem. Because of its interest in promoting full and fair disclosure of its ability to dictate the form and content of financial information the SEC took a keen interest in the subsidiary-based offerings. As a result of its investigations, the SEC began receiving additional disclosures from "carve outs" in mid-summer 1983. The Commission's concern, according to its then Chief Accountant, Clarence Sampson, was letting the public know the "true costs" (and profits) of subsidiaries. Late in 1983, the SEC formalized its opinion in Staff Accounting Bulletin No. 55. "Allocation of Expenses to Subsidiaries, Division and Lesser Business Components." Its position is clearly stated: "the historic income statements of the (subsidiary) should reflect all of its costs of doing business". This is in sharp contrast to Statement on Financial Accounting Standards No. 14, "Financial Reporting for Segments of a Business Enterprise." It does not allow for the allocation of

corporate costs including: general corporate expenses, interest expense, and income taxes to segments for financial reporting purposes.

To improve control and efficiency, it is not unusual for the home office to centralize the acquisition and payment of certain costs on behalf of its subsidiaries. Examples include common costs (e.g., accounting, legal, data processing, etc.) and separable costs (e.g., as insurance, leases, salaries, etc.); these costs are then reported under general corporate overhead by the parent and not charged to the subsidiary directly. Historic financial statements of subsidiaries that omit parent-absorbed costs are not useful in judging the merits or risks of a prospective investment.

This issue is but one part of the entire consolidation issue now before the Financial Accounting Standards Board (FASB). SAB 55 and the earlier SAB 54 on "Pushdown Accounting" are attempts by the SEC to put out spot fires in the complex, fundamental area of consolidated financial statements. The Commission is eagerly awaiting progress in the FASB project on consolidations that will address the basic concepts of accounting for affiliations between entities.

### **Reporting Requirements for Subsidiaries**

SAB 55 applies to any subsidiary or affiliate whose separate financial statements are included in a filing with the Commission, including unconsolidated subsidiaries. Parent-incurred expenses specifically mentioned in the bulletin for consideration in the allocation process are:

1. Officer and employee salaries
2. Rent or depreciation
3. Advertising
4. Accounting and legal services
5. Other selling, general and administrative expense.

When all the costs attributable to the

subsidiary are not reflected in the subsidiary's financial statement, revision of the historic financial statements is necessary to reflect the parent-absorbed expenses. The acceptable format for an adjustment is income before taxes followed by the expenses not previously allocated, income taxes, and then adjusted net income. This is known as a pro-forma adjustment.

Identifying the amount of parent-absorbed expenses and the related disclosures are covered in SAB. The suggested steps for accumulating the necessary information include:

1. Identify expenses paid by the parent that directly relate to the subsidiary. These expenses must be fully reflected in the subsidiary's financial statements.
2. Identify expenses paid by the parent that relate to the subsidiary but are not directly identified with that unit. A reasonable part of these expenses must be allocated to the subsidiary. Incremental or proportional allocation methods are examples of methods that are acceptable.\*
3. If the expenses paid by the parent are materially different than what the subsidiary would have paid on a "stand alone" basis, estimate what the subsidiary's expenses would have been in that situation.
4. Develop the necessary disclosures. The financial statements should include disclosures of the allocation methods used, an assertion by management that the method is reasonable, and the estimate of the expenses if the subsidiary had contracted for the services rather than the parent.

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\* Statement on Management Accounting 4B, "Allocation of Service and Administrative Costs", National Association of Accountants, 1985, provides guidance on this issue.

The last major provision covering

parent-subsidiary expenses requires pro-forma income statements prepared in accordance with Article 11 of Regulation S-X when cost-sharing agreements will be terminated or altered. The objective of pro-forma statements is to show the impact of significant changes on the historic statements "as if" they had occurred earlier. So, even if all costs are reflected in the subsidiary's historic statements, changes in the agreed-to method of sharing future common costs must be reflected retroactively in pro-forma statements. The predictive power of historic statements is enhanced by restating them for changes in agreements that will have continuing future impact.

### **Compliance with Requirements**

During the period June 1983 to February 1985 we noted thirteen prospectuses and preliminary prospectuses appearing in Investors Dealers Digest and Moody's Investor Services in which a parent company was carving out a subsidiary. All of the offerings were initial public offerings, (see Table 1).

In all but two instances, majority control was maintained by the parent, the majority of the companies chose to list their shares on the over-the-counter market, and many of the offerings were by companies in high-tech or trendy industries.

Many of the registered sales fell through, with timing being the main reason for withdrawal. This problem was discussed in an article by Lee Berton, that appeared in the December 20, 1983, The Wall Street Journal. Berton noted a trend downward in the size or price of subsidiary offerings and problems with their timing as a result of the issuance of SAB 55.

In our sample, expense disclosures varied among the companies; however, most subsidiaries included the parent-incurred costs in their historical financial statements. The reasons for this

included established practice, contractual agreements, and the provisions of SAB 55.

The second most common disclosure method for the allocated costs was the pro-forma adjustments. This form is acceptable only when the subsidiary's financial statements were previously audited and used by outsiders. Pro-forma adjustments have the advantage of leaving the historic statements intact and, therefore, avoiding any criticism of manipulation.

In this group of offerings, only one company claimed that no adjustments were necessary to allocate parent-incurred expenses. This assertion might be challenged based on the findings of other companies.

The most common method of allocating expenses was actual or approximate (based on specific identification). Other methods were used and included incremental cost, proportional allocation and contractual agreement. Management's assertions about the related party nature of these expenses took the form of management opinions and comparisons with services provided by third parties.

### **Effectiveness of SEC Measures**

SAB 55 has resulted in more informative disclosures of the relationship between a parent and its subsidiaries when they are issuing stock. The required disclosures put the subsidiary on a stand alone basis and help the SEC carry out its mission to seek full and fair disclosure. If the practice of carving out subsidiaries persists as a financing technique, the reporting requirements will also evolve and become more uniform. Negotiated agreements will probably increase in popularity as a "basis" for allocating costs because of their certainty and simplicity in resolving the issue of parentprovided services.

Many of these questions will be resolved when the FASB completes its project on consolidations. Until then, the SEC's vigilance will no doubt continue to influence reporting in this area.

Table 1  
 COMPANIES 'CARVING OUT' SUBSIDIARIES  
 JUNE 1983 TO FEBRUARY 1985

Prospectus Date	Subsidiary	Parent Corp.	Parent's Interest After Offering <sup>1</sup>	Shares of Common Stock Offered (In thousands)	Business Description
11/10/83 (P)	Alco Health Services Corp.	Alco Standard Corp.	70%	3,600	Pharmaceutical wholesaler
2/08/84	American Fructose Corp.	American Maize Products Co.	70%	2,500	Fructose (sweetener) manufacturer
2/14/85 (P)	Datron Systems Inc.	Hale Systems Inc.	75%	600	Satellite communication systems
12/09/83	Devry Inc.	Bell & Howell	85%	1,500	Post-secondary education
1/09/84	El Torito Restaurants Inc.	W. R. Grace & Co	73%	3,000	Mexican restaurants
2/01/84 (P)	Fingerhut Co., Inc.	American Can Co.	81%	3,700	Direct mail marketer of general merchandise
11/10/83 (P)	Herman's Sporting Goods Inc.	W. R. Grace & Co.	58%	4,000	Sports equipment & clothing retailer
10/18/83 (P)	Info Optics Inc.	Anacomp, Inc.	74%	2,100	Computer output storage & retrieval devices
12/06/86 (P)	Knox Lumber Co.	Southwest Forest Industries, Inc.	35%	2,400	Lumber, building products & hardware retailer
12/08/83	Super Rite Foods Inc.	Rite Aid Corp.	49%	2,550	Food, grocery & tobacco wholesaler
08/10/83	Total Systems Services, Inc.	CB&T Bancshares	82%	500	Bankcard data processing services
06/21/83 (P)	Wabash Data Tech Inc.	Kearney-National Inc.	86%	1,400	Computer magnetic storage media
03/28/84	Xidex Magnetics	Xidex Corp.	78%	1,020	Computer magnetic storage media

(P) = Preliminary prospectus  
<sup>1</sup> Assumes underwriter's options weren't exercised

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