Available online at www.sciencedirect.com

SCIENCE DIRECT

Accounting Forum 28 (2004) 159–165

ACCOUNTING FORUM

www.elsevier.com/locate/accfor

A case against the consolidation of foreign subsidiaries' and a United States parent's financial statements

Paul E. Holt*

Department of Accounting and CIS, Texas A&M University, Kingsville, Campus Box 184, Kingsville, TX 78363, USA

Received 15 May 2003; accepted 20 October 2003

Abstract

Generally accepted accounting principles in the United States usually require that companies which own more than 50% of the voting stock of foreign corporations prepare consolidated financial statements. The foreign financial statements must be recast into US GAAP and the foreign currency financial statements must be translated into US dollars. Alternative methods of translating foreign currency have major impacts on consolidated financial statements and on the behavior of management. Further, foreign subsidiary financial statements which are recast into US GAAP are less useful than the originals, and US users cannot analyze them without reference to the foreign environment. The interests of financial statement users are better served by alternative presentations of foreign currency denominated accounts rather than by consolidation.

Keywords: Business environments; Consolidated financial statements; Financial ratios; Foreign currency translation; Foreign financial statements; Foreign subsidiaries; Information content

1. Introduction and purpose

Multinational Corporations (MNCs) based in the United States typically have a number of subsidiaries in various foreign countries. It is not uncommon for the consolidated entity to have more sales outside the United States than domestically, and the various subsidiaries often operate with little interference from the parent company management. A substantial

* Tel.: +1 361 593 3927; fax: +1 361 593 3912.
E-mail address: phtamuk@yahoo.com (P.E. Holt).

0155-9982/$ – see front matter © 2004 Elsevier Ltd. All rights reserved.
doi:10.1016/j.accfor.2003.10.001

portion of many foreign subsidiaries' financing, investing, and marketing activities is done in the foreign environment.

But according to generally accepted accounting principles (GAAP) in the United States, MNCs which own more than 50% of the voting stock of foreign corporations are required to prepare consolidated financial statements. There are two exceptions to this requirement: (1) when control is temporary, and (2) when control does not exist, despite the majority ownership. This process of consolidation is by no means trivial. When consolidation is required, three major steps have to be taken: (1) the foreign financial statements must be recast into US GAAP, (2) the foreign currency denominated financial statements must be remeasured and/or translated into US dollars, and (3) the foreign financial statements must be combined with those of the US parent.

The purpose of this article is to demonstrate that the foreign currency translation and consolidation problem does not have a solution and that the interests of financial statement users are better served by an alternative presentation of foreign currency denominated accounts.

2. Problems in recasting GAAP

The problem of foreign currency translation and subsequent consolidation begins with Step 1, the recasting of a foreign subsidiary's financial statements from foreign GAAP to US GAAP. Clearly, consolidation cannot be achieved unless this step is first taken, but from the viewpoint of foreign managers, the recast statements are less meaningful than the originals, and US users cannot analyze them without reference to the foreign environment.

For example, a Japanese or Korean subsidiary may have a debt to equity ratio that is extremely high by US standards (Holt, 2003, p. 71; Iqbal, 2002, p. 262; Mueller et al., 1994, p. 115). Such a high ratio does not typically mean that the foreign subsidiary is a highly speculative investment, as it would suggest if observed in a US subsidiary. Instead, the ratio may indicate the Japanese or Korean firm's stability in its own environment and its credit worthiness. As another example, Japanese earnings per share may be drastically lower than expected of a US subsidiary, yet be higher than average in Japan, a phenomenon that is not typically a function of different accounting rules (Aron, 1989). Thus, even when the Japanese subsidiary's financial statements are recast into US GAAP, an analyst simply cannot evaluate the subsidiary's results of operations and financial position without reference to the Japanese business and cultural environment.

Differences in business environments are often substantial and are reflected in the individual firm's financial statements (Holt, 2003, pp. 2–13; Iqbal, 2002, pp. 120–135; Mueller et al., 1994, p. 96). Switching from one GAAP set to another does not solve this interpretation problem. In fact, recasting from foreign GAAP to US GAAP is likely to destroy or distort relationships that are meaningful in the foreign environment.

3. Problems in remeasurement and translation

A massive literature on the subject of remeasurement and/or translation of foreign currency financial statements prior to consolidation has developed over a period of several