Deelnemingen
Goodwill
Jaarrekening

METHODS OF ACCOUNTING FOR INVESTMENTS IN THE STOCK OF SUBSIDIARY COMPANIES (INCLUDING THE EQUITY METHOD)

by P. A. Wessel, LLM, RA, Son, The Netherlands

Chapter I. Appraisal of the economic and juridical setting of financial statements in The Netherlands

1. Brief outline of the historical situation

The problems involved in presenting, in the annual report of an enterprise, a statement of its equity, its financial position and its periodic results have, for a long time, been approached by the leading accounting professionals in The Netherlands from a scientific, business economic respect. We should pause here, at the beginning of our consideration, because it is only in this manner that the "climate" in which in The Netherlands the shareholders' interest is portrayed, can be clearly understood. Typical of the approach in this country is the attention which is habitually paid to the problems of valuation and the distinction which is made between the fluctuations in the equity which stem from the results and the equity fluctuations which do not.

Discussions of this subject have been evoked and stimulated by the replacement value theory put forward in the 1920's by Professor Th. Limperg, of Amsterdam. Now is not an appropriate occasion to examine this valuation theory which concerns the significance of price changes in general - that is to say not only the influence of inflationary rises. It must be appreciated, however, that this theory produced in The Netherlands at an early stage the viewpoint that for subsequent valuation and profit determination the importance of historical costs (i.e. amounts actually expended) diminishes considerably. The consequence of this has been that the connection between the bookkeeping entries made during the reporting year and the financial statements drawn up at the end of that year, although not broken, has become so loosened that the balances in the nominal ledger are no longer automatically taken up, but are first subjected to a process of evaluation before being considered acceptable for inclusion in the annual financial statements.

For a long time, therefore, Netherlands practice has attributed less significance to the view that the preparation of financial statements by adoption of the recorded historical costs provides a safeguard against manipulation than to the necessity for reliability in determining the equity and result. Thus the possibility of valuing above historical cost was introduced in my country and it is not felt to have asked too much of the expert judgement and integrity of those habitually involved with the preparation of financial statements (accountants, managers, supervisory directors, auditors, etc.). Cf. net asset valuation, pag. 127.

Now, it is a well-known fact that the scientific nature of a discussion by no means always ensures that a consensus of opinion will ultimately be reached as regards the question at issue. This phenomenon has also appeared with respect to the treatment of business economic problems related to financial statements. What is more, new opinions are regularly being brought to the fore, often determined not only by evolution in economic reasoning but also by developments in the socio-political field.

It would not be right, therefore, to suggest that the replacement value theory or, more broadly, the application of current values, has become generally accepted in The Netherlands. On the other hand one would definitely underestimate its importance if one were to measure it against the frequency of its application in annual accounts published by companies listed on the stock exchange.

In the juridical field however, a serene calm reigned for many decades. The Netherlands legislator was, until mid 1971, content with very brief regulations regarding the annual reporting of corporate companies. The practice of reporting could take place anywhere within that broad juridical spectrum - even though here and there - for example in the sphere of creating and utilising silent and secret reserves - there was undeniable evidence of a lack of constraint.

2. A new impetus in the legal and the professional field

Around the beginning of the seventies, it was commonly felt that the time was ripe for the modernisation of the legal requirements relating to the financial statements of enterprises. On May 1, 1971 a new Act on Annual Financial Statements of Enterprises (Wet op de Jaarrekening van Ondernemingen)[1]) (further referred to as: the Act) came into force applicable principally to companies with a corporate capacity (N.V.'s and B.V.'s) and cooperative societies. For financial statements the Act defines: the structure of the balance sheet and the profit and loss account together with the explanatory notes thereto.

Bearing in mind the results of business economic discussions, the legislator has, in the course of drafting this Act, sharply emphasised the general principles for the drawing up of financial statements and not the details thereof. First and foremost as the purpose of the financial statements, he has ordained that they must enable the reader to form a sound judgement on the financial position and results of the enterprise and, to the extent that the financial statements permit, on its solvency and liquidity. In order to realise this purpose, the Act says in general terms that the financial statements must reflect fairly and systematically the size and composition of the enterprise's equity at the end of the financial year of the results obtained during that year.

Now valuation rules, in the literal sense, are totally unknown to the law. The legislator, in relation to the so important question of valuation in the annual financial statements, has confined himself to one principle and that is that the assets and liabilities must be valued according to generally accepted rules, that is to say, acceptable as able to give a true and fair view of the equity and results. The principal purpose which led to the inclusion of this definition was to make an end to the possibility of creating, maintaining or utilising silent (invisible) or secret reserves. During the parliamentary discussion of the Act a clear distinction was maintained from the above all fiscally coloured concept "good business practice", which can cover manipulations with silent and secret reserves. In contrast to the legal position in a number of other countries, as is very distinct in the

---

[1]) Since mid 1976 embodied in book 2 of the Civil Code.

German Federal Republic, no identity is prescribed in The Netherlands between equity and results according to the financial statements on the one hand and according to the annual tax return on the other. Any difference between the two must be analysed in order to define the necessity of a provision for deferred taxes in the financial statements.

What bases in fact satisfy the specified criterion of economic acceptability has, from the beginning, been the object of permanent consultation between representatives of the accounting profession and employers' and employees' organisations.

The professional accountants' body in The Netherlands (Netherlands Institute of Registeraccountants), does not issue to its members binding regulations in respect of the presentation of financial statements. Moreover, the future recommendations of the International Accounting Standards Committee will not, initially, be considered as binding because the Netherlands Institute will, rightly, only ascribe a binding power (for its members) after these standards have been adjudged as economically and socially generally acceptable. The published statements of the above-mentioned tripartite consultative body do not, in the strict sense, bear the stamp of binding regulations but rather a review, yet indicating those bases of valuation encountered in practice which do not conform with the purpose of the financial statements as stated in the Act.

Now just a few words on the regulations included in the Act regarding disclosures in the balance sheet. The legislator also wished to limit himself in this respect to a minimum of regulations, thereby prescribing only in general terms that the aim of fair and systematic presentation of the financial position and results should always take precedence in the combining, analysing and arranging of the data in the balance sheet. This means that additional disclosure can be necessary beyond that detailed in the Act if the purpose of the financial statements so requires. Moreover, prescribed forms are not included in the Act so that the lay-out of the financial statements and the sequence of separate data therein is optional, so long as the requirements of fairness and consistency are satisfied.

Up to now mention has only been made in passing of the determination of results. What regulations has the legislator provided for that? You will not be surprised with the answer: very few. Firstly it must be stated that neither in the Act nor elsewhere in Netherlands law is there to be found a precise definition of profit or loss. Nor does the legislator approach these concepts in a negative sense by establishing which equity movements may not be attributed to profit or loss. Thus again the treatment of these concepts and also the business economic doctrine which must serve them as a guideline are placed in the hands of the drafters of financial statements. It would at this point be going too far to enter into a lengthy business economic discussion of the profit or loss concept.

This does not alter the fact that, generally, the essential feature of profit is considered to be the availability for distribution, i.e. not required in the enterprise for the continuity of business operations. In The Netherlands the view is not generally held that the profit and loss statement should be drawn up according to the all-inclusive principle. On the contrary, it is usually regarded as incorrect to advance the equity by including in profit increases in value attributed to price movements of assets essential to maintain the productive capacity (see also page 129). On the other hand it is permissible, according to Netherlands concepts, to incorporate equity movements which contain positive profit characteristics directly into the equity without first passing them through the profit and loss statement, provided, however, that these movements are of an exceptional nature (e.g. non-recurring material adjustments of pension or taxation provisions, or important income or expense items relating to preceding years). Naturally any such action should be effected with necessary care and disclosure so that those responsible do not incur the blame for profit manipulation. The statements of the tripartite consultative body (page 122) emphasise this strongly.

In fact, the legal requirements with respect to the results are limited to the already familiar sounding demand that, also for the determination of results, standards must be applied which can be considered acceptable in economic and social life, supplemented with a few brief regulations regarding the minimum extent of specifications of the result in the profit and loss statement. Just as with the balance sheet, it may be necessary for the data and its analyses and arrangement in the profit and loss statement to exceed the minimum requirements in order to give a fair and systematic presentation of the results.

Chapter II. The particular Netherlands legal regulations concerning the inclusion of participations in the financial statements

1. The concept of participation

The Act includes a number of articles containing regulations solely for application to participations. The legal requirements with respect to the treatment of participations in the financial statements stipulate that participations in enterprises not having the legal structure of an N.V. or a B.V. also fall under the above-mentioned regulations. As examples can be considered: a participation in the members' capital of a co-operative society, in a partnership or in a limited partnership. On the other hand the Act is applicable only to participations held by enterprises with a legal structure subject to this Act. There are no legal requirements for participations held by partnerships, limited partnerships or sole traders. Insofar as the financial statements of these forms of enterprise may play a role outside strictly private business circles, it can nevertheless be expected that the regulation appearing in the Act will, to some extent, have a reflective effect and that this regulation, with the necessary changes, will often be applicable in these cases.

The Act does not define a participation. However, the Act does construe as an irrefutable supposition, that in the case where an enterprise holds for its own account, directly or indirectly, at least one quarter of the issued share capital of an N.V. or a B.V., there is talk of a participation. Criteria other than participation in share capital, from which the existence of a participation could be concluded, such as the power to appoint more than half the members of the managing board or the supervisory directors of the company, do not appear in the Act. These can, nevertheless, be considered as implicit in the demand for fair presentation.

2. Information to be disclosed with regard to the value of participations in general

With respect to participations, the Act requires that all information about the valuation thereof be provided as fairly as possible. According to the official explanatory memorandum this means that in the balance sheet the total value which in compliance with the general valuation rule, is attributed to the participations over 50% and to those not over 50% must be disclosed as two separate items. Furthermore the Act prescribes that the change in value of the participations in the course of the financial year must be fairly explained, whereby the part of the change in value arising from the results of the investees must be separately shown. The total amount receivable from or due to investees must be stated separately in the balance sheet or in the notes.

3. Majority participations

More strict prescriptions are included in the Act regarding majority participations. A majority participation exists when an enterprise participates, directly or indirectly for its own account, to the extent of more than half of the issued share capital of another enterprise. It is somewhat surprising that the legislator considers the capital criterion definite without further provisions. It is certainly not exceptional that Netherlands companies issue preference shares with limited profit rights. The exclusive ownership of these shares can, under certain circumstances, produce a majority participation of which, however, the economic significance is small; the enterprise which owns all the ordinary shares with unlimited profit rights will, economically speaking, have a majority participation but not from a legal standpoint. In this last instance, an enterprise truly wishing to provide reliable information will indicate a majority participation. The requirement to give a fair presentation of the value of a participation, the Act states, will only be satisfied in the case of a majority participation if the notes forming part of the financial statements of the investing enterprise include either consolidated or combined financial statements or the financial statements of the investees, all complying fully with the requirements of the Act. The requirements relating to majority participations in foreign enterprises can, however, be satisfied by including the respective financial statements, prepared in accordance with foreign law, in the notes or by depositing them with the Commercial Register. Consolidated financial statements are appropriate whenever there is a question of a subordinate relationship between the investing enterprise and the investee; combined financial statements - which otherwise could just as well be consolidated because intercompany accounts and profits are eliminated - are suitable where these enterprises are on the same level with each other.

The legislator has not expressed an opinion regarding the question whether consolidation, respectively combination or the furnishing of separate financial statements is required. Thus the Act does not contain any regulations covering:

participations of a temporary nature;

participations subject to difficulties regarding transfer of capital or profits;

participations which do not fall under "sole management" of the investor enterprise, a concept known in German company law;

participations wherein an activity is carried out which differs entirely from that of the investing enterprise, etc.

The solution of these problems is left completely to the judgement of those drafting the relevant financial statements and to the accountancy profession, guided by the business economic doctrine.

Naturally, the Act contains an exemption from the regulations described in this paragraph for enterprises, the entire capital of which is held, directly or indirectly, by an enterprise which does itself comply with these reporting requirements.

4. Information re name and registered office of majority participations
The Act also includes an article which regulates the mention in the notes of the name and registered office of the investees. The mention of name and registered office either in the financial statements or in a separate list deposited with the Commercial Register is in principle required with respect to each majority participation and, furthermore, any other participation if the value thereof amounts to at least 15% of the assets of the investing enterprise. In order to prevent the financial statements from becoming top-heavy with needless information, a general exception is included, which states that disclosure of names and registered offices can be omitted, if the value of the aggregate assets of the enterprises of which the names are not disclosed is not in excess of 15% of the consolidated value of the assets of the investing enterprise and those enterprises wherein it has a majority participation.

Where there are significant reasons against the disclosure of the name and registered office of a participation in the financial statements, the investing enterprise may be exempted by the Minister of Economic Affairs from the disclosure obligation for a number of consecutive years not exceeding five. Little or nothing is known of the contents of the exemption policy being conducted by the Minister.

5. Disclosure of the results of participations
Legal requirements directed towards the treatment of the results of participations in the profit and loss statement hardly exist. No-one should be surprised after what was written on page 122. TheAct only states that profits and losses of participations shall be shown separately in the profit and loss statement.

6. Exemption from disclosure of the results of consolidated participations
Investing enterprises of which financial statements are included in consolidated or combined accounts may omit disclosure of the results of their consolidated participations in their profit and loss statement.

Chapter III. A few words on the tax treatment of participations
In principle double imposition in the field of company tax is not intended. This is achieved by attributing the so-called participation exemption to the recipient enterprise if the latter is subject to company tax. This exemption ensures that all advantages and disadvantages, however described, with respect to a participation are excluded from assessability to company tax in the hands of the participating enterprise. This does not apply to losses arising on the liquidation of the investee company.

The criteria for the existence of a participation in the fiscal sense differ considerably from those which appear explicitly in the Act. In fiscal terms there is already talk of a participation with an investment amounting to 5% of the investee's capital held since the commencement of the accounting year. Should this criterion not be met because the 5% limit is not reached, there can still be talk of a participation in the fiscal sense whenever retention of the related asset corresponds with the normal business practice of the investing enterprise or the acquisition of that asset has served the general interests.

It is easily understandable with the fundamental distinction mentioned in the previous chapter between, on the one hand, the commercial financial statements and on the other the tax statements, that the results of participations incorporated in the commercial financial statements differ from those in the tax statements. It is usual in my country to include an amount for taxation in the profit and loss statement which corresponds with the apparent income before tax (matching principle) and, as has already been said, to pass the differences of tax due according to the tax return for that year through the deferred taxation provision. Now that the tax treatment of the results of participations has been outlined, it will be clear that the foregoing proposition does not hold good for differences in the results of participations accounted for in the fiscal sense. For in this case it concerns profit elements objectively exempted from tax. Thus it is usual, in computing the tax chargeable in the profit and loss statement, to remove from the base amount - the profit before tax - any possible profits or losses of participations-in a fiscal-sense, included therein.

Chapter IV. The manner in which participations to be consolidated are actually treated in the financial statements

The discussions in this and in the following chapter are based upon what can be found regarding majority and minority participations in Netherlands literature, supplemented by knowledge gained on the one hand from the study of a large number of annual reports published by Netherlands enterprises and on the other acquired from the exercise of a public accountant's practice in The Netherlands.

1. Participations to be consolidated versus majority participations. Joint ventures

As may be deduced from the title to this chapter, I shall not build this dissertation on the contrast between majority and minority participations - a distinction which recurs mostly in literature and is also encountered in the Act - but on the contrast between participations to be consolidated and participations not to be consolidated. The consolidation element, namely, appears to play an important part.[2])

In the greater number of cases, majority participations are consolidated and the concepts coincide. However, there are majority participations which are not consolidated, for example, because of the reasons summarised on page 124. On the other hand there are, in Netherlands eyes, important classes of minority participations, namely the joint ventures, with regard to which a rapidly growing tendency can be observed during the last decade towards line-by-line consolidation up to and including the participatory percentage, even despite the fact that the Act does not impose consolidation. The need, nevertheless, to proceed to consolidation and in that way to develop the minimum regulations in the Act still further, has been experienced in practice on the grounds that fair presentation is a first requirement of financial statements. As joint ventures are usually considered those economic entities of any legal form (e.g. N.V., B.V., partnership, limited partnership), which are jointly set up by a limited number of companies in order to realise their common aims, be it in a specific technical field or whith res-

[2]) In order to avoid any misunderstanding arising from Anglo-Saxon language usage, it must be stated here that one is alluding only to the line-by-line consolidation and not the one-line consolidation through valuation of participations in associated companies on the equity basis.

pect to a certain market. People clap their hands because the necessary economic potential needed for the realisation of the aim far exceeds the powers of each of the founders individually. The founders then do not only share in the results of the joint venture in proportion to their participation but must also share in the same ratio for e.g. financing.

2. The valuation of participations to be consolidated. Net asset value method
In The Netherlands, participations to be consolidated are, in the majority of cases, valued at the net asset value at the moment of valuation with due regard for the participatory percentage, calculated on the basis of the investee's balance sheet. This method of valuation which is championed in the statements of the tripartite consultative body, is applied both at the time the majority participation is first acquired as at later balance sheet dates. In the first instance, if the moment of acquisition does not coincide with a balance sheet date, the net asset value is calculated on the basis of interim information supplied by the investee. However, it often occurs that the moment of acquisition is, for the sake of convenience, fictitiously moved to the nearest balance sheet date unless such substantially damages the fair presentation of the accounting for results.

The explanation of the predominant position of the valuation at net asset value in so far as it relates to participations to be consolidated is as follows. For a long time now the conviction has been evident in The Netherlands that the fair presentation of financial position and results in the case of subordinated groups could only be effected by way of consolidated information. According to the formal legal requirements, the statutory (parent company) financial statements and not the consolidated statements had to be adopted or approved by those competent in the enterprise. In that way the custom evolved of submitting the financial statements together with the consolidated statements to the competent persons and - with public companies - to circulate such more widely. Through the Act the consolidated statements have even become a document with the official status of a part of the notes to the financial statements of the enterprise which forms the group holding and thus also an object for adoption or approval by the bodies so authorised.

Bearing in mind that publication of the financial statements of public and larger private companies is compulsory, the legal basis for consolidated information for the public was, in this way, also substantially re-inforced. The existence of Siamese twins, which already for many decades have led the financial statements and consolidated statements, has gradually developed the opinion that a coherent and fair presentation is only achieved when no other equity or result are presented in the financial statements than is shown in the consolidated statements (principle of equality). With respect to participations to be consolidated, the principle of equality leads logically to a valuation at net asset value. For the auditor it may be added that he was thus not faced with the dilemma of whether he was able to issue unqualified reports upon two financial summaries with differing equities and results relating to the same economic entity, a practice which is quite usual in countries with a more formal approach. Thus one has an example of a situation wherein the legislator who in fact has not prescribed any concrete rules of valuation, in a roundabout way has, de facto, only given an opportunity to one method of valuation.

However, it must be admitted that the predominance of the net asset value method does not imply uniformity in valuation. Certainly, the net asset value is usually derived from the balance sheet of the investee, with the application of the customary principles of valuation of the participating enterprise and with due regard to the going concern concept, but just these principles are the least alike. For a good understanding: the net asset value is not thus necessarily the same as the equity appearing in the balance sheet of the investee.

One of the most striking disparities is caused by the fact that some enterprises value at historical cost, others, on the contrary, at current cost. In this way one can distinguish two categories of net asset value - the one computed with a historical basis, the other with a current basis.

The principle of equality may sometimes involve a negative net asset value. It is not exceptional in such cases to take the net asset value at nil, while the remaining difference is booked off against the amount due from the investee. In fact this procedure illustrates an economic responsibility of the parent company for losses throughout the group which may surpass juridical liability.

3. Intercompany profits, etc.

In spite of valuation at net asset value, justice is not in some cases sufficiently done to all aspects connected with a majority participation. One can here, in the first instance, think of the intercompany profits included in the valuation of the group assets. If these were eliminated, should this also, according to the principle of equality, be effected in the financial statements of the participating enterprise. In fact, there is no question here of a typical consolidation problem; even in the preparation of unconsolidated financial statements a clear idea must be formed of the business economic status of intercompany transactions. One essays by preference to do this by creating a provision for unrealised profits with the supplying enterprise or to reduce the value of the asset obtained by the acquiring enterprise. With the latter method, doubt is in fact cast upon the acceptability of the profit surcharge.

If it is the investee whose accounts are adapted in these ways, then these procedures also work through indirectly in the net asset value of the majority participation in the financial statements of the participating enterprise. If an investee has omitted to account in the proper manner for unrealised intercompany profits then a provision for unearned intercompany profits is made in the financial statements of the participating enterprise which is sometimes deducted from the net asset value of the related majority participation.

There is however a marked trend in The Netherlands, also to be traced in the statements of the tripartite consultative body, which holds the view that there is no absolute necessity to eliminate intercompany profits. Elimination should be omitted (and be explained in the notes to the financial statements) if the goods flow continuously and in normal quantities through a vertical series of group related enterprises whose activities are attuned, so long as the mutually calculated prices can be and, in fact, are compared regularly with prices calculated by unrelated enterprises operating in the same markets ("arm's length" transactions).

By applying the matching principle, taxation of the eliminated intercompany profits is deferred to the year in which this appears in the profit and loss statement.

If, too, there are certain disadvantages or obligations for the participating company regarding its holding of a majority participation, the investor must make a provision therefor in its financial statements or make mention thereof in the notes to the financial statements because the disadvantages will not yet, naturally, have been discounted in the net asset value.

4. Intercompany accounts

It is not customary in my country to make corrections to the net asset value in order to eliminate intercompany accounts, existing between the participating enterprise and the investee, from the balance sheet of the investor. The removal of intercompany accounts is - in contrast to the elimination of intercompany profits which can affect the net asset value - indeed looked upon as a typical element of consolidation technique. I would recall that the total amounts receivable from and payable to investees must be separately shown in the balance sheet of the participating enterprise.

5. Computation of the results of participations to be consolidated

The principle of equality means in terms of the determination of results that, apart from any minority interest, the entire result of the investee must, in the year it is attained, be incorporated in the profit and loss statement of the participating enterprise. Hence the part of the difference between the net asset value at the beginning and at the end of the year of a participation to be consolidated, which corresponds with the result obtained in that year by the investee, is credited or debited to the profit and loss statement of the participating enterprise. Insofar as, however, the difference corresponds with, e.g. revaluation of the investee's assets in order to bring them to current values at the balance sheet date, or additions to the investee's equity arising from price-level accounting, such difference is added to the revaluation account for participations in the participating enterprise and is therefore not included in the profit and loss statement.

Distribution of a dividend by the investee is, in the net asset value method, dealt with in the balance sheet of the participating company as a transfer between the assets participation and, for example, liquid resources or receivables. Problems with respect to dividends out of pre-acquisition reserves do not arise, because dividends never appear in the profit and loss statement of the participating enterprise.

That in this manner, too, the undistributed profit of an investee is included in the results of the participating enterprise has never, in The Netherlands - in contrast to that which is the case in other countries - aroused much disquiet. There are no legal impediments, especially because of the absence of a legal definition of the profit concept. In fact, there is no reason fordisquiet or worse, for are we not moving in the sphere of participations to be consolidated, thus of enterprises wherein the participating enterprise has a decisive influence upon all essential matters (including capital and profit remittances). In such a case the declaration of a dividend is a mere technicality. Neither can the absence as yet, of an actual cash remittance be seen as an argument because even the profit of the participating enterprise itself is often, at the time of payment, not available in cash. An inconsistency with regard to the moment of accountability for profit arising from normal trading transactions does not exist either. In trading transactions profit is also taken at the moment of delivery - and not at the time of settlement by the debtor. And that, too, when one has less control over the settlement than in the case of a dividend from an enterprise in which one exercises a decisive influence.

Can one, however, say that no decisive influence exists with joint ventures which are also valued according to the net asset method? In that instance accounting for the complete result is still required because the enterprise, jointly with others, is in fact realising its own aims.

Moreover, even if in my country one is not afraid to include the undistributed profit of an investee in the profit and loss statement, that does not alter the fact that the participating enterprise frequently considers with profit distribution the profits reserved in these investees, whether by adding explicitly such amount of reserved profit to a reserve for revaluation of participations or by transferring such amount to free reserves so that they equal those of the investee. Neither system is, in practice, an exception.

6. *Goodwill*

It is a common occurrence that the consideration emanating from a participating enterprise on the acquisition of a participation to be consolidated does not correspond with the net asset value of the latter. Seeing that, as already mentioned, the net asset value is computed with the help of standards of valuation customarily used by the participating enterprise, silent reserves are automatically attributed to the assets and liabilities of the investee. The difference between net asset value and consideration, assuming for the present that the consideration is the greater, represents the goodwill paid. It is, in principle, usual to calculate the goodwill at the date of acquisition of the participation to be consolidated, or at the nearest balance sheet date if, for convenience, that is used.

In The Netherlands goodwill is usually considered to be the discounted value of the estimated future super profit of the enterprise. Because of the activity of competitors, this super profit is mostly subject to rapid wastage. When, nevertheless, one can frequently determine the appearance of super profit in an enterprise over a longer period this is, according to the view held in my country, due to ever new impulses to the profitability of the enterprise. In that way, purchased goodwill is, in a comparatively short time, replaced by self-generated goodwill. This is the so-called "reproduction concept" upon the basis of which depreciation of purchased goodwill is considered, from a business economic point of view, unavoidable. Hence, not to depreciate is seen as being incompatible with a fair presentation. On the other hand, the capitalisation of self-generated goodwill is everywhere, economically speaking, looked upon as inadmissible; legally it is forbidden, under the requirements that intangible assets may not be valued in excess of the total amounts expended thereon (a kind of a hidden valuation rule). The most logical treatment of purchased goodwill is to write it off completely against the results in the year of acquisition or within relatively few (3 to 5) years thereafter; in the latter case combined with a separate asset account for the part not yet written off. This approach is often chosen in my country. The results after the acquisition of the participation are thus reduced by that part which was attracted by previous owners.

In addition, the method whereby goodwill is charged in the year of acquisition against the free reserves or the reserve for revaluation of participations, in order to reduce equity, is also often utilised. If so, the amount paid for goodwill is looked upon as being a loss of equity or a perhaps fiscally advantageous farewell dividend for the vendors. The most frequently heard justification for this procedure is the concept of prudence - the aversion to balance sheet inflation. It must not, however, be forgotten that this approach leads to the equity of the new entity being lower and the results higher than in the case of annual depreciation of goodwill. Ergo, the performance of management is reflected as favourably as possible. Although, strictly speaking, this argument is never displayed, one may assume that it is not infrequently an important, if not decisive factor in the selection of the method of treatment of goodwill.

The difference between the net asset value on acquisition and the quid pro quo from the participating enterprise can also be negative (the consideration being the smaller of the two amounts). In most cases there is no question of a "lucky buy" - the benefit can then be credited to equity and after disposal of the participation may be passed through the profit and loss statement - but an accounting with adverse factors and obligations which are bound to the participation to be consolidated and with which therefore no account can be taken in the calculation of the net asset value so that a provision will have to be created for the difference in the balance sheet of the participating enterprise.

In the foregoing it has been tacitly assumed that the consideration for the acquisition of the participation to be consolidated does not consist of shares in the participating enterprise. If, however, this were the case then it can happen that the shares representing the quid pro quo have a value in excess of the nominal value attributed to them - or, in other words that account is taken of a share premium. The question may then arise, whether or not to increase the equity of the participating enterprise with that part of the share premium which exceeds the net asset value. Exclusion can be defended by pointing out that, as a result of the modalities of the purchase consideration, the participating enterprise cannot, in principle, pay goodwill because this is, in fact, mutually settled in the price determination by the succeeding shareholders of the participating enterprise. Performance considerations, whether or not expressed, can actually play a part with this compulsory once and for all writing off of goodwill - treatment, just as with the aforementioned voluntary once and for all writing off of the goodwill against the reserves. Others, on the contrary, defend the standpoint that it may not affect the presentation whether or not the purchase consideration of the participating enterprise consists of shares; the supporters of this point of view thereby distinguish the goodwill as an asset with the participating enterprise and the entire share premium as a part of the equity.

7. Translation of foreign currencies

Participation in enterprises established in other countries has, in the past, been quite common in Netherlands business circles. The translation of financial statements expressed in foreign currencies has thus, already at an early stage, been in the limelight.

It cannot be expected that a fundamental treatment of currency problems will be placed in a paramount position in this paper. I must confine myself to a few brief observations.

The typical Netherlands approach to the translation of financial statements expressed in foreign currencies agrees with the general content described in chapter I strongly leavened by a feeling for current values and therewith for relativity to the significance of sums expended in the past. The enthusiasme has never been particularly great for forms of translation techniques, originating from the United States and based on dualism - such as the current-non current method, the monetary-non monetary method and Lorensen's temporal theory, which propagate a mixture of current and historical exchange rates. These techniques were, too, scarcely applied in pure Netherlands enterprises; as opposed to enterprises established in my country but managed from the United States.

On the other hand, there are many supporters in The Netherlands of the monistic current rate method, both in theory and in practice. This translation system has apparantly been found the most convenient complement to the system of valuation at net asset value. Theorists nevertheless focus attention on the fact that the official exchange rates, as a result of disturbances in the international economic equilibrium, often do not reflect a fair view of the purchasing power relationships of the various currencies. Therefore the standpoint is often taken that the official, frequently manipulated, exchange rates should not be used but only the purchasing power parities. The latter rates better reflect intrinsic value relationships than official rates, which indicate values in external dealings.

There is no argument that the determination of the purchasing power parities is no simple matter. In addition, it must be pointed out that the advantages of purchasing power parities are only done sufficient justice when the assets and liabilities in the currency of the foreign enterprise are valued at current values. For in the long term, upward tendencies in prices and downward movements in purchasing power can be the two sides of the same coin. Were this process indeed carried out to perfection then the value of the participation to be consolidated, other things being equal, would not change when seen from the participating enterprise.

In practice, however, there is no trace of a really systematic application of any extent of purchasing power parities. The majority of enterprises whose financial statements were consulted employ an official exchange rate for the translation of the net asset value of foreign investees, and move in the direction of purchasing power parities only when the disruption of economic life in the foreign country leads to the official exchange rate apparently no longer providing a reliable presentation.

Practice does not provide a uniform picture concerning the treatment in the financial statements of differences arising on changes in translation rates. If the reserve for revaluation of participations in the equity of the participating enterprise represents the profit retained by the investee than a corresponding part of the exchange difference must be incorporated therein. Furthermore, the remainder of the exchange difference is often dealt with in another reserve, sometimes also in the profit and loss statement. With regard to the moment at which a change of rate becomes effective, some apply the reality, others fictitiously move the moment to the nearest balance sheet date, calculating the entire result at the old or the new rate. In the notes to the financial statements the system adopted is usually explained. It is assumed that the results of a chosen system of treatment of translation differences is regularly reviewed as regards its standard of reliability and, where necessary, corrected and simultaneously referred to in the notes.

8. Bases of valuation other than net asset value. Equity method, pooling of interest method
Although the valuation of participations to be consolidated on a net asset value basis occurs on a large scale in all Netherlands enterprises of any significance, other systems of valuation do occasionally appear. In order to avoid violating the reliability requirement, the difference between the value attributed to the participation to be consolidated and the investee's equity is mostly explained in the notes or a reconciliation is included between the equity and results according to the financial statements and according to the consolidated statements of the participating enterprise.

Valuation of participations to be consolidated according to the equity method as recognised in the Anglo-Saxon sphere of influence does not take place with purely Netherlands enterprises. The equity method resembles the net asset value method insofar as both systems take account of the entire result for the year of the investee and not only of the part to be distributed therefrom. An important difference, which because of the Netherlands interpretation of the reliability requirement is prohibited from being applied in my country, creates the situation that goodwill computed on the acquisition of a participation to be consolidated is not written off.

The system of valuing at the nominal value of the investee's share capital crops up sporadically in literature and practice concerning participations to be consolidated. This system is sometimes applied in circumstances where the conditions for "pooling of interests" are given: the merging of equivalent partners by an exchange of the issued shares of one of the parties for specially issued shares of the other. The difference between the nominal value of the newly issued shares, on the one hand and the exchanged shares on the other is dealt with in the reserve of the issuing enterprise. Goodwill and share premium are not expressed. At the time of drawing up the first financial statements and the first consolidated statements following a pooling of interest, one is however faced with the reliability requirement and the net asset value method of valuation for the exchanged shares intrudes. In this way one arrives at almost the same result as if one had, from the beginning, included these shares at net asset value and had immediately written off any possible goodwill against equity. Thus, according to the Netherlands view, pooling of interests provides no more than a temporary solution.

Chapter V. The manner in which participations which are not to be consolidated are actually treated in the financial statements

1. The concept: participations not to be consolidated
Participations are mostly not consolidated when their possession does not give the participating enterprise a decisive influence. This is the case when the participating enterprise does not have more than half the votes or when, despite a majority of votes, it does not appoint more than half the members of top management or the Board of Supervisory Directors of the investee. We have seen already that in the special situation of a joint venture these criteria are insufficient. On the other hand it can happen that although the majority criteria are satisfied, a participation is not consolidated because for extraordinary reasons the effective exercise of power does not, or cannot, take place, or because consolidation, through

a misleading blend of figures relating to sharply differing enterprises, may markedly damage the reliability aspect of the consolidated statements.

Although the elements of the "participations not to be consolidated" are in practice generally the same as for "minority participations" - a presumption, as we have seen, of the Act - the two groups are not, in theory, identical.

Participations not to be consolidated are, moreover, noticeably more heterogeneous in content than participations to be consolidated.

We shall see that this conclusion is not without significance.

In the first place we are still faced with the question whether a participation not to be consolidated, wherein no decisive influence can, in effect, be exercised is distinguishable from an investment in shares which also contains no decisive influence. Practice shows that the function of an investment consists of providing income and/or investing capital as a hedge against inflation, without the exercise of more than formal influence upon the enterprise whose shares form the investment. On the other hand, with the help of a participation not to be consolidated, a far less neutral connection is brought to life; the participating enterprise is definitely planning to exercise influence whether offensively or defensively in the investee in order to serve its own interests as well as possible. This service does not have to be expressed positively in the receipt of dividend or increase in the value of the participation not to be consolidated but can take any number of more or less concrete forms. Participations not to be consolidated can be subdivided into two main groups, namely participations which are retained with an eye to

- financial interests
- the influence related thereto.

In the former group of investments the financial interest lies in the share in the income or in the equity of the investee. The latter group comprises participations in organisations, mostly of a non-profit making nature with little equity of any significance, which look after, for example, the common interests of complete branches of industry. Often, for subordinate or more or less incidental reasons, these organisations have the legal form of a company or co-operative society although that of a foundation would be suitable as well. Another category in the second group includes participations retained so that, with the influences related thereto, the raw materials supplies or sales outlets of the investing enterprise may be favourably affected.

2. Further particulars regarding the treatment of participations not to be consolidated

First and foremost it must be said that little attention has been given either in literature or in practice to participations not to be consolidated. A rather recent statement of the tripartite consultative body stands up for a valuation at, or at least disclosure of, the net asset value, provided the information required is available. In recent literature, however, a plea has been made for valuation based upon yield and not upon net asset value, on the grounds that the undistributed profit is unattainable for the participating enterprise. Both sources obviously deal with participations from the first group mentioned in par. 1. When we examine the various available financial statements it appears that participations in this group are not infrequently valued on a net asset basis and almost never on a yield basis.

The net asset value can, presumably, only be applied in the case of participations which are accompanied by a large measure of influence, just as for majority participations which, because of divergent business activities, are not consolidated. Even more it applies in those cases where mention is made that the net asset value is computed with due regard for the principles of valuation of the participating enterprise. Practice shows that this type of participation despite the absence of a decisive influence, is still felt to be so closely bound to the own enterprise that the yield basis of valuation is not considered to present fairly the significance of the participation.

Valuation at cost, nominal value or nil is presumably the most often used for participations not to be consolidated which are retained because of the possibilities of influence only. One cannot go much further in this case than to express a supposition, because the notes do not usually provide sufficient information.

A positive opinion which can be expressed is that the elimination of intercompany profits and intercompany accounts does not take place.

When the net asset value method is applied to the valuation of participations not to be consolidated, the proportionate share of the profit obtained is probably included in the profit and loss statement. In some cases it is quite evident that this is so, in others it is wrapped in silence. Probably because the result of the participation not to be consolidated generally does not have a material effect on the total result, the question of the undistributed profit is treated lightly. During the tripartite consultations no objections were raised to either procedure.

Understandably, separate treatment of possible goodwill only occurs with the application of net asset value. The impression exists that goodwill is mostly written off the equity of the participating enterprise, sometimes also charged in the profit and loss statement. Thus there is no material difference from the treatment of goodwill paid in participations to be consolidated.

With regard to the translation of foreign currencies, the same problems arise with participations not to be consolidated as with those to be consolidated so that no further comment is necessary here.

June, 1975