論　説

Why Has the Shift toward Full Consolidation Not Been Achieved in Corporate Financial Reporting?

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1. Introduction

Consolidated financial statements are assumed the vital information of companies that wish to be financed through global capital markets and to provide the investors with useful communication mediums. The most basic issue of this reporting practice is, however, still in controversy. That is: which of full or proportionate portion of subsidiaries' assets, liabilities, revenues, expenses, and incomes should be consolidated where the parent company owns less than 100 per cent of the subsidiaries' common stock? When full consolidation is used, the treatment of minority interests and the scope of the subsidiary are to be under difficult discussion, and the fact that the parent exercises control over the whole resources of the subsidiaries is concealed when proportionate consolidation is conducted. In other words, it is the choice between the entity theory (the economic unit approach) and the proprietary theory of consolidated financial reporting[1]. Current

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1) Usually there are three consolidation theories specified: entity, proprietary and parent company theory. The proprietary theory or proportionate consolidation is at one extreme, and the entity

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practice is based on both full and proportionate consolidation, but it is somewhat closer to the latter. Some attempts have been made to shift it towards full consolidation, but it has to be said that they are failed for the present.

In this paper, by tracing and contrasting the U.S. and other countries' experiences on the development of consolidation accounting, a tentative explanation will be given that the shift toward full consolidation is not achieved because of the evolutionary character of accounting change. Section 2 will make a survey of works on the definition of full and proportionate consolidation, on the support for the full consolidation, and on two processes of accounting change. Section 3 and 4 will examine the evolutionary and revolutionary change of consolidation accounting. Since the ways consolidation emerged are different in the U.S. and the other countries, each section is divided into at least two parts: American experience and that of the others. Finally, section 5 will conclude the discussion.

2. Literature review

2.1 Definition of full and proportionate consolidation

Before exploring the discussion, the definitions of full and proportionate consolidation need to be provided. In this paper, following orthodox interpretation of Bierman, Jr. [1992] will be used:

> [Full consolidation is the method in which] all the assets and liabilities of the investee firm are added to those of the investor firm. ... Proportionate consolidation [is the method] in which any material investment in common stock by a corporation gives rise to the need to consolidate. (Bierman, Jr. [1992], p.5)

It can be said, therefore, that the choice between full and proportionate consolidation is the matter of whether or not the minority interest should be included in the consolidated financial statements. Under the full consolidation, the minority interest is integrated with parent's interest in the consolidated statements, while under the proportionate

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theory or full consolidation at the other. The parent company theory is between these extremes, to which the current practice comes closest. Both the parent theory and the proprietary theory are based on the same assumption that the reporting entity is not the group as a whole, but the parent company itself. Since the proportionate consolidation is considered the purest form of the parent company theory (FASB [1991], par.118), two extremes are examined in this paper to simplify the following discussion.

consolidation, only the interest of the parent company is reflected in the statements and the minority interest is excluded.

Obviously, these accounting methods of consolidation are closely associated with what is called consolidation theory (entity theory, proprietary theory and parent company theory) or concepts of consolidated financial statements (economic unit concept, parent company concept and proportionate consolidation concept). In the well-cited Discussion Memorandum issued in 1991, Financial Accounting Standards Board (FASB) in the United States compared the three competing concepts and stated that under the economic unit concept,

> the assets, liabilities, revenues, expenses, gains, and losses of the various component entities are the assets, liabilities, revenues, expenses, gains, and losses of the consolidated entity. Unless all subsidiaries are wholly owned, the business enterprise's proprietary interest ... is divided into the controlling interest (stockholders or other owners of the parent company) and one or more noncontrolling interests in subsidiaries. Both the controlling and the noncontrolling interests are part of the proprietary group of the consolidated entity, even though the noncontrolling stockholders' ownership interests relate only to the affiliates whose shares they own. (FASB [1991], par.63)

It is clear that under this concept, full consolidation method of accounting is to be used. On the other hand, FASB wrote, in contrast to the economic unit concept, that under proportionate consolidation concept,

> only the parent's share of a subsidiary's assets, liabilities, revenues, expenses, gains, and losses in included in the consolidated financial statements. (FASB [1991], par.114)

The similar analysis was pursued by Baxter and Spinney [1975][2]. From these observations, it comes out that the economic unit approach (or entity theory) and proportionate consolidation concept (or proprietary theory) of consolidation accounting go counter to each other since the one results in adoption of full consolidation and the other in proportionate consolidation.

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2) Baxter & Spinney [1975] proposed four concepts: proprietary,, parent company, parent company extension, and entity. The parent company extension concept is an effort to capture more features of the entity concept than parent concept, but it appears to have still same logic with parent company concept and proportionate concept because it excludes minority interest from the calculation of consolidated income and goodwill.

2.2 Support for the full consolidation

In the current practice of consolidation accounting, neither full nor proportionate consolidation is adopted in its purest way. Although the minority interest in subsidiaries' assets, liabilities, revenues and expenses constitutes the elements of consolidated statements, that interest in the income, equity and goodwill is excluded from consolidation[3]. For example, International Accounting Standard 27 clearly states that minority interests in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent (par.15 (b)) and that minority interests in the net assets of consolidated subsidiaries are identified and presented in the consolidated balance sheet separately from liabilities and the parent shareholder's equity (par.15 (c))[4]. In this respect, the existing practice (or parent company concept) embraces the conflicting treatments of minority interest together: "including" for assets, liabilities, revenues and expenses and "excluding" for income and goodwill.

Recently, much has been written about desirability of shifting current practice to full consolidation in preparing consolidated financial reporting. One of the most effective attempts to this shift was the Exposure Draft issued in 1995 by FASB. In this draft, FASB described that in the expected consolidation,

> the amount of the net income or loss attributed to the noncontrolling interest is neither an expense nor a loss but an allocation of consolidated net income of a business enterprise or change in net assets of a not-for-profit organization. That is, net income attributable to the noncontrolling interest is deducted from consolidated net income to compute net income attributable to the controlling interest. (FASB [1995], par.23)

Although FASB rejected the goodwill attributable to the noncontrolling interest to be consolidated[5], it clearly aimed at full consolidation of incomes. This perspective is consistent with the view in such literature as Dickinson [1913] and Moonitz [1951].

3) See Baker, Lembke and King [1996] for the particularly clear discussion by using diagrams.

4) The treatment of goodwill is described in IAS 22, which limits it to the acquirer's interest (par.41).

5) In the same draft, FASB stated: if a parent acquires less than a 100 percent interest in a subsidiary, the noncontrolling interest in the subsidiary shall be reported at its proportionate amount of the fair value of all of the subsidiary's identifiable assets and liabilities. Goodwill shall not be attributed to the noncontrolling interest. (par. 27)

Moonitz went so far as to say that not only net income but also goodwill attributable to the noncontrolling interest should be consolidated.

> If a parent pays $150,000 for an entire proprietary equity recorded (after audit and appraisal) at $120,000, the conclusion follows that the fair value of that equity is $150,000. ... If the parent paid $120,000 for an 80 per cent interest, the same result should be obtained. A price of $120,000 for an 80 per cent interest indicates that the whole proprietary equity is worth $150,000; therefore consolidated goodwill is again $30,000. (Moonitz [1951], p.58)

Among the recent academic works on this subject, Beckman [1995] and Nurnberg [2001] seem to be prominent in that both persuasively argued for advantages of full consolidation[6]. In Beckman [1995], the review and synthesis of the financial economics literature on corporate control transactions came out at the support for the economic unit concept. In the latter, the desirability of consistent use of the entity theory for four consolidated statements (e.g. consolidated income statement, consolidated balance sheet, consolidated retained earnings statement, and consolidated cash flow statement) was demonstrated.

2.3 Two processes of accounting change

In spite of all these theoretical efforts, however, it must be remembered that the shift toward full consolidation has not been achieved at least for the present. Full consolidation has never been set as an accounting standard, let alone as an accepted practice. FASB deleted its aim at full consolidation in 1999 in the revised Exposure Draft (FASB [1999])[7].

This is a very interesting phenomenon from the perspective of accounting change. The word accounting change here is used in order not merely to indicate the change of alternative methods of accounting standards but to mean the change of accounting as part of wider organizational system. It seems possible to see an organization in the dynamic process where it adapts itself to the environment gradually over long time periods, and at

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6) In contrast to the support for full consolidation, there seems little effort to approve of the proportionate consolidation. Bierman, Jr. [1992], however, is an exception. It contributed to find that the financial statements of corporations consolidated on a proportionate basis provide financial information useful to financial analysis.

7) In 1999, FASB narrowed its deliberation from that on consolidation policy and procedure to that only on policy, which seems to reflect the difficulty of this project. This suspension of consolidation procedures will last until completion of consolidation policy, a part of which is planned in the second quarter of this year (http://accounting.rutgers.edu/raw/fasb/project/consol.html).

the same time where it encounters periodic discontinuities (Tushman and O'Reilly [1996]). In other words, both organizations and accounting, the latter being functioning in the former, are subject to the ecological pressures in which they transform through periods of evolutional adaptation punctuated by revolutionary change.

According to Edwards [1991], these two processes of change in accounting are described as follows:

> Change may come about as the result of an invention (revolutionary change) or the gradual development of a new technique as the result of numerous minor modifications to an existing practice (evolutionary change).　(Edwards [1991], p.113)

In this paper, this classification will be applied to discuss how consolidation accounting has come to be what it is now. By doing this, the reason why the change toward full consolidation has been hardly succeeded will be tentatively explained. The discussion starts with the emergence of consolidation accounting. Since the ways the consolidation accounting emerged in the United States and many other countries are different, the inquiry will be divided into at least two parts: American experience and that of other countries. The evolutionary and revolutionary change in these two contexts will be discussed in turn.

3. Evolutionary change of consolidation accounting

3.1 Emergence of consolidation accounting

Moonitz once described "consolidated statements are indigenous to American financial reporting" (Moonitz [1951], p.10). It appears clear enough that this is because the development of consolidated reporting in the United States is remarkably unique compared with that in many other countries. This uniqueness partly lies in the fact that American accountants adopted consolidated reporting at a time when there were no effective disclosure rules requiring alternative presentations. On the other hand, accountants in other countries first considered the use of consolidated statements at a time when the legislation already required companies to their file accounting data for public inspection. (Walker [1978], p.99)

In the U.S., not until the stock market crash of 1929 led to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 were there established accounting standards. Holding company form had already played an important role in its economy before this rules by the last decade of the nineteenth century and accountants faced the need to report on this type of business structure. The characteristic of holding company is that it operates together with many subsidiaries as though they all are constituents of a single company, while they remain separated as legal entities. From the economic point of view, obviously their unity is substantial and their separation is only a matter of form. Thus, American accountants had to and were able to create consolidation accounting without making any rules that regulated legal entity's reporting. The American classic literature on consolidation accounting such as works by Dickinson, Lybrand, Finney and Newlove were all written in this period. These private accountants contributed to make consistent principle of consolidated statements in this country. When the regulation S-X regulated the form and content of all financial statements to be filed with the SEC, it was not separated entity's statements but consolidated statements that were required. (AISG [1973], par.16)

On the other hand, before holding company form became popular, many other countries' accounting profession already introduced the legislations requiring the presentation of the financial statements of individual companies. In the U.K., the model articles of the Joint Stock Companies Act 1856 included provision that proper accounting records would be kept, that a profit and loss statement and balance sheet would be presented to each annual general meeting and an audit of these statements would be carried out[8]. Other countries such as Germany, France, Netherlands, and Japan also have the same history in the sense that the legal requirement of the financial disclosure was made in the latter half of nineteenth century. Holding company form appeared after these rules, and it was in 1948 that the Companies Act requires the preparation of group accounts (which normally take the form of consolidated financial statements) in the U.K. In Germany, Netherlands, Japan and France, consolidated financial statements are legally required in 1965, 1970, 1975, and 1985 respectively. (Ordelheide et al. [2001])

3.2 American experience- full consolidation as a convention

When the situation in which consolidation accounting emerges is different, the consequent development naturally does not take the same form. In the U.S., accountants invented

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8) The Joint Stock Companies Act 1844 made provision for the maintenance of adequate accounting records and for the presentation of a balance sheet, but these requirements were removed by the Joint Stock Companies Act 1856 (Cooke, Choudhury and Olusequn Wallace [2001], p.2581).

consolidated financial statements in order to report the financial information of holding company. It seems possible to generalize that accounting problem of holding company is that parent-only statements allow the directors, by taking advantage of subsidiary legally separated, to report their financial positions and operating results as they wish them to be. This possibility will be avoided by the adoption of any consolidation accounting. Consolidating parent's and subsidiaries' statements are the one way of consolidation[9].

Consolidated statements became the institutional tool for communication with holding companies' shareholders because the legislative requirement of parent-only statements was absent before holding company organization appeared. As the holding companies became increasingly important, American accounting profession did not seek to the legislation demanding the individual reporting which was prevailing in other countries.

At the same time, the most American holding companies held 100 per cent or almost 100 per cent of the stocks of their subsidiaries (Walker [1976], p.77). Under this circumstance, the relationship between holding company and its subsidiaries is quite similar to that between the head and branch offices in one company, which are engaging in the same or interdependent operations. It is quite sensible, therefore, that American professions prepared the consolidated financial statements by simply adding subsidiaries' assets, liabilities, revenues and expenses to those of parent, just in the same way of branch accounting.

What was more advantageous for the development of consolidated statements was that the choice between full or proportionate consolidation could be avoided in this case. There was no, or negligible, minority interest and it was not necessary to take trouble to decide whether or not to include them in the accounts. In other words, even when parent company held less than 100 per cent of the stock of subsidiaries, they reasonably used full consolidation rather than proportionate consolidation. From this historical analysis, it is understandable that full consolidation is a convention[10] in the U.S. literatures.

3.3 Other countries' experience- amplification of individual statements

On the other hand, many other countries, where there were already effective requirement of parent-only statements before emergence of holding company, were faced difficulty.

9) The other way of consolidation accounting is the equity method, which will be discussed afterward.

10) For example, Bierman, Jr. [1992] describes full consolidation as conventional and traditional (p.6).

The accountants in these countries were used to report accounting information based on legal entity, but at the same time, like in the U.S., any kind of consolidation accounting was considered necessary to solve accounting problem of holding company as long as this type of business form exists. What made the situation difficult was that it was not easy to relinquish parent-only statements they are used to and to construct a completely different accounting practice. It seems quite natural that they sought to improve already-existed financial information. Peloubet adequately observed this evolutionary change with regard to experience in the U.K. as follows:

> The British accountants lean much more to the adjustment and amplification of the holding company statements than do their colleagues in the United States (Peloubet [1955], p.31).

In focusing on the individual financial statements, the accountants paid careful attention to the valuation of investment in the stock of subsidiaries[11]. Logically enough, the accounting problem of holding company was considered in line with the valuation of the investment. When it is valued at cost and the dividend from subsidiaries is recognized as revenue, it is possible for the directors of the holding companies to go so far that they can deceive information users. Dickinson explained[12]:

> It is within the power of the directors of the holding company to regulate its profits according, not to facts, but to their own wishes, by distributing or withholding dividends of the subsidiary companies, or even to largely overstate the profits of the whole group by declaring large dividends in those sub-companies which have made profits, while entirely omitting to make provision for losses which have been made by other companies in the group (Dickinson [1904], pp.189-190).

To avoid this over-discretion, many accountants approved and tried in practice equity method on the parent-only statements[13]. Using the equity method can be considered another way of consolidation accounting. The Equity method is often called "one-line consolidation," because when this method is applied, the parent's share of the only subsidiaries' incomes or losses will be consolidated and its share of the subsidiaries' assets,

11) Edwards [1991] demonstrated the evolutionary change of the first company that published a consolidated balance sheet in the U.K. This may well be the simple application of well-established branch accounting procedures as American companies did. Edwards [1991] itself, however, accept the possible influence of American convention (p.129).

12) Although Dickinson is famous for promoting consolidated statements in the U.S., his background as an English Accountant often made him consider from the viewpoint of parent-only statements.

13) The early and famous example is the statements of Lever Brothers, co. in the U.K.

liabilities, revenues and expenses will not. In the parent's individual statements, the investment in the stocks of subsidiaries is revalued according to recognition of the parent's proportion of the incomes earned or losses incurred by subsidiaries after the date of acquisition. Edwards and Webb revealed the equity method was most used among several group accounting methods from 1919-1925 in the U.K. (Edwards & Webb [1984]). Even in the U.S., equity method was alluded by respectable numbers of accountants (Finney [1922], pp.42-46; Newlove [1926], pp.13-14[14]) when they refer to parent company's own financial statements.

The profound deliberation about one-line consolidation was made even after the U.S. and the U.K. introduced the legislation requiring the consolidated statements. For example, Takatera [1971] in Japan gave a rigorous survey of argument over equity method, and Walker stated in 1978:

> For example, if consolidated statements were intended to overcome the deficiencies of conventional methods of handling intercorporate investments so as to obtain a "better" impression of a parent's overall earnings, then equity accounting would seem to be a perfectly adequate substitute for consolidated reporting. (Walker [1978], p.106)

However, this one-line consolidation had a grave problem in practice. Using equity method means recognizing unrealized profit in the parent's statements, because it is not until the subsidiary pays dividend to its investor company in cash that the profit is finally realized[15]. From this point of view, modified equity method was proposed[16]. As will be seen later, however, the revolutionary change occurred before this problem had received an enough attention and deliberation.

4. Revolutionary change of consolidation accounting

4.1 American experience- no revolutionary change

In the U.S., it seems that no revolutionary change has occurred as far as consolidation accounting is concerned. American accountants are used to prepare, audit or analyze

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14) Newlove called this method "actual value method" (Newlove [1926], p.13).

15) Finney [1922] justified equity method because the holding company and its subsidiary are so closely related that the profits of the subsidiary are virtually profits of the holding company which owns the subsidiary (p.42).

16) See Griffin, Williams and Welsch [1966] for instance.

full-consolidated financial statements since they first invented this method and regard it as a convention.

However, it must be noted that in the practice full consolidation is not always approved even in this country. Nurnberg [2001] points out that the consolidated income statement, the consolidated balance sheet and the consolidated cash flow statement can be said that they assume a consolidated entity perspective using full consolidation, but the consolidated retained earning statement definitely assumes a different perspective in the existing practice. This means that retained earnings attributable to the noncontrolling interests are not consolidated and in this sense, proportionate consolidation is clearly chosen. It is beyond this paper to explain this practice, but there is no doubt that, even inside of the U.S., proportionate consolidation is preferred when it comes to earnings calculation.

4.2 Other countries' experience- influence of American consolidation

In other countries, revolutionary change has occurred as an influential ingress of consolidated statements from the United States. The U.S. played a powerful role in rapidly internationalizing economy with many big businesses as its background. At first British accountants, then gradually German, Dutch, Japanese, French and other countries' accountants came to notice that a different way of consolidation is conducted in the U.S. In addition, more practically, not a little number of companies sought to list their stock in the New York market and had to prepare consolidated financial statements.

Fortunately or unfortunately, both equity method and consolidated statements aimed at improving the information presented by holding company's separate statements. Furthermore, preparing consolidated financial statements in addition to the individual statements is far easier than acquiring unanimous agreement for recognition of unrealized profit from using equity method. As a result, in most of the countries other than the U.S., the attempts to amplifying the individual financial statements were abandoned and both legal entity's statements and consolidated statements came to be provided together. The acceptance or rejection of equity accounting became a non-issue[17] (Walker [1978], p.107).

17) After this, equity method was revived as a assistance to consolidation accounting, applied to unconsolidated subsidiaries. The distinction has to be made, however, between equity method used in consolidated statements from that used in separate legal entity statements.

More than five decades have been passed since Company Act legislated group accounts in the U.K. and almost twenty years since the law in France was modified to oblige companies to consolidated statements. It can be said that at the present most accountants in these countries are more or less used to consolidation of assets, liabilities, revenues and expenses of parent and subsidiaries, that is, American way of consolidation. There still remains, however, the difference from American mode of consolidation in their thought. While in the U.S. full consolidation is sometimes assumed the ideal method of consolidating statements, in those countries the vector towards proportionate consolidation seems in existence.

This may be due to the fact that, as seen in the previous section, many accountants (sometimes even American profession) have developed the discipline of equity method which is logically consistent with amplification of the individual statements. As FASB told in its inquiry into conceptual and theoretical foundation of consolidation accounting, proportionate consolidation has the potential as a replacement for the equity method (FASB [1991], par.136). In other words, the equity method and the proportionate consolidation relate each other very closely.

By using the equity method, the income presented in parent-only income statement shows the number that contains parent's income and proportionate share of the parent in the subsidiaries' incomes. Similarly, by using the proportionate consolidation, only the parent's proportionate interest of its subsidiaries' incomes will be added to parent's income. The same income number will be reported both in the parent-only income statement using equity method and in the consolidated income statement using proportionate consolidation. What is different is whether the parent's investment in the stock of subsidiaries is substituted by the parent's proportionate share of the subsidiaries' individual assets and liabilities. They both exclude the minority interest of income.

The idea of these two methods that only the portion of the subsidiaries' incomes is consolidated to the parent's income number is the same, and it may not be always denied that, consciously or not, the accountants in other countries than America see consolidation from this point of view. They view the parent's individual financial figure as a starting point, since it already functioned in many ways before consolidated statements. Still now, consolidated financial statements are based on the holding company's accounts and are prepared from the holding company's point of view (Birch [1997]).

Especially such countries as France and Germany, parent-only financial statements still have grave reason for existence, and its income number functions with a considerable importance. Hoarau [1995] states neither the taxable result nor the profit available for distribution to shareholders is derived from consolidated financial statements (Hoarau [1995], p.229), and legal entity's financial statements are used in this purpose18). In these countries, individual financial statements can be neither neglected nor relinquished and the vector towards separated entity's data necessarily remains.

5. Conclusion

In this paper, it was demonstrated that in the U.S. full consolidation becomes a convention and that in other countries proportionate consolidation evolutionally developed after the revolutional change of influential ingress of consolidated financial statements from the U.S. Today the same consolidation accounting both in the U.S. and in the other countries is needed for the comparability of financial statements across the world. Current practice has both characteristics of full and proportionate consolidation, but it is said close to proportionate one. Some researchers insist on the shift towards full consolidation, but the attempt is failed for the present.

In 1978, Walker wrote that international accounting standard for consolidated financial statements was a product of "compromise" and these rules were not consistent with any of the commonly-outlined rationales of consolidated reporting (Walker [1978], p.108). Today IAS 3 which Walker argued on was superseded by IAS 27, but it is sill inconsistent with either entity theory or proprietary theory. However, from the view that accounting is a phenomenon which is so interdependent with its context and subject thereby to the vicissitudes of other organizational practices and concerns (Hopwood [1987], p.213), this "compromise" will inevitably go on. Walker deplored that the question about whether or not equity method is used in parent company statements was neglected and

18) Recently in these countries, consolidated financial statements are used not as a supplement to parent company statements to avoid the accounting problem of holding company, but as a means of international accounting harmonization. Under this circumstance, consolidated statements are considered as the "barrier" against the American or Anglo-Saxon influence. For the French and German perspective, see Hoarau [1995], and Glaum and Mandler [1996] for instance. In Japan, such a clear agreement on how to deal with harmonization problem does not exist, and there are arguments that a new company act only for the large and public companies is urgently necessary (for example, see Ando [2001]). See also Kuroda [2001] and Kikuya [2001] for the general explanation about Japanese accounting standards in context of international harmonization.

abandoned in the setting process of IAS 3. At this time, full consolidation is to be abandoned because the profits without minority interest are firmly rooted in many countries, possibly including even the U.S. given the fact that proportionate consolidation is used in the calculation of retained earnings.

Accounting does not change logically. It is difficult to think that the current practice will be converted to full consolidation only because it is theoretically "right". The shift toward full consolidation means the adding minority interests of income and goodwill to the parent's interests of them, which results in radical conversion of the gradually-evolved income concept.

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