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SOME ASPECTS REGARDING THE THEORIES OF CONSOLIDATED FINANCIAL STATEMENTS

Theoretical
article

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JEL Classification

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Abstract

Although accounts consolidation was used in practice from the early 1900's its theoretical basis were developed later in concordance with the rise of concepts like "entity" and "group". The aim of this article is to examine the literature in the accounting field regarding the consolidation theories developed over the years. In order to discuss the different opinions regarding the consolidation theories we used the descriptive approach. As a result we tried to explain how these theories appeared and developed, respectively what consequences have their use in preparing consolidated financial statements. The results of the study suggest that every theory has certain aspects which differentiate it from the others in terms of recognition of subsidiary income and reporting net assets of the subsidiary. However, from all theories analyzed, the entity theory takes into account several guidelines of maximum importance when preparing consolidated financial statements: "You can't own yourself!", "You can't owe yourself money!", "You can't make money selling to yourself."

1. Introduction

During the 1970s and early in the 1980s academic research in the accounting field was largely analytical rather than empirically-based. Among the diversity of topics adopted by the researchers back then is the history of ideas concerning the preparation of consolidated statements. In this regard, Walker (1976, 1978) approaches consolidation accounting from a global point of view, associating the emerge of consolidated statements with the industrial development in countries like USA, U.K., Canada, Australia, New Zealand and several European countries.

Examining the history of consolidated statements, Walker (1978) noticed that the circumstances which led to the initial use of consolidated statements were different from country to country. For example, American companies started to consolidate the accounts in order to attract new funds (e.g. United States Steel Corporation, 1902). More than that, focusing on the American and British experience, Walker's study shows that accountants had different opinions regarding the purpose of consolidated statements. In the case of UK, for example, the aim of consolidated financial statements was to reflect the position and earnings of a holding company group, viewed not as a series of separate entities but as an economic unit (Robson, 1936). Meanwhile, the use of consolidated statements in the early 1900s in the USA shows that they were substituting the parent-company reports, considered not sufficient to present group's position and performance (Walker, 1978).

Related to the need of consolidated statements, several theories were developed, considered more or less appropriate to be taken into consideration by academics and practitioners of the field. The rationales for using one or another were discussed by several researchers, different points of view being stated. The next section provides insights regarding literature opinions on consolidation theories.

2. Literature review

While the interest on consolidating accounts for multinationals is bigger than ever nowadays, this practice is older than 100 years. Like we stated before, the first consolidations that took place in the early 1900s led to the developing of different theories regarding why, what and how to consolidate. If the reasons for consolidation were at first ambiguous, the aspects that matter in consolidated account (e.g. definitions of control, reporting entity, ownership, parent and subsidiary) where the "milestone" of each theory developed in this regard. As a result, the accounting literature has developed several theories regarding consolidated statements: proprietary theory, entity theory, parent company theory (considered to be

"classics"), but also enterprise theory, parent company extension theory, and residual equity theory.

One of the firsts which discussed the proprietary theory, known as the pro rata market value method was Hendriksen (1965). In his opinion, "proprietorship" represents the net value business for owner(s). Considering the double entry accounting principle, assets minus liabilities equals proprietorship, it is obvious that the business value is composed from the initial investment plus accumulated net income minus any amounts withdrawn by the owners (Hendriksen, 1965, cited by Koehler, 1969). Because it excludes the minority interest from the consolidated financial statements, the proprietary theory is considered to be more applicable in the single proprietorship business form. Practically, the entity is considered to be an extension of the owner(s), accounting information being treated from his perspective. In other words, the proprietary theory is a "theory of wealth" where the increase of an entity's net income is considered to be an increase in the owner's wealth. (Newby, 2006)

An extended version of the proprietary theory developed by Paton & Littleton was the enterprise theory advanced by Soujanen, (1954, 1958). His theory revolves around the idea of companies becoming institutions due to the large parts of income retained for their use in order to reduce the dependence on external financing (Soujanen, 1958). Despite the legal obligations of managers to the stockholders, the rights of the stockholders are subsidiary to the group (Soujanen, 1954). Known as the "social theory", the enterprise theory evolved over time in the concept of corporate social responsibility according to which manager are required to be responsible for economic, social and ecologic impact of entity's activities.

With the raising of corporate form of organization, applying the proprietary theory to large companies has faced several difficulties. As a result, accounting theory turned to an entity approach which was considered to be better suited when developing consolidated financial statements.

The firsts "advocates" of the entity theory were Paton & Littleton (1940), considered by many the founders of modern accounting standards. According to Paton & Littleton the business income represents the income of the enterprise itself which remains like this until dividends are paid to the shareholders. Opposite to proprietary theory, according to entity theory, the consolidated firm is considered a distinct entity, separate from the owner(s). Although in its early days, no particular distinction was made between liabilities and owner's equity, the equation being assets = equities, Moonitz (1961) extends the entity's interest in consolidations, eliminating intercompany profits, liabilities, and receivables

with strict segregation of minority interests. Basically, according to the entity theory, the entity owns the assets and liabilities, and its operations are taking place for the benefit of the owners.

According to the parent company theory, the parent doesn't own the net assets of subsidiaries but has effective control over them even when minority interests exist. Davis & Largay (2008) argue that when the entity is reporting the net income for consolidation purposes, the parent company theory takes into account only the parent company's share of subsidiary income. Any share of net income of the non-controlling interest is considered to be an expense, being reported as a liability in the consolidated financial statements. As stated by Beams et. al. (2009), the parent company theory considers that consolidated financial statements are an extension of parent company statements, their preparation being made from the parent company stockholders' point of view.

As Baluch et al. (2010) noticed the parent company theory is more appropriate to be used in cases when the parent acquires and implicitly holds control over 100% of its subsidiaries. If any other cases, the information from the consolidated financial statements would not be relevant. Furthermore, the parent company has evolved leading to the parent company extension theory according to which minority interests are not treated neither as equities nor as liabilities, being presented somewhere between these concepts.

Another theory, developed from the investors' perspective is the residual equity theory (Staubus, 1959). Staubus considers that the greatest risk is supported by common stockholders who invest in a company which is why they should have enough information regarding the financial position and performance of the entity. From all company's stakeholders the residual equity holders support the greatest risk taking into consideration the fact that if something wrong happens with the company (e.g. bankruptcy), they will be the last in line to recover their investment. As a result, accounting should be done according to the residual equity holders' perspective.

Each of the theory discussed above targets a specific audience: the parent company, the group as a whole, the investors, the common investors, control and minority interests etc. In this regard, the evolution of several theories of consolidation is in accordance with a specific public of the consolidated financial statements. For example, while the advocates of the parent company theory consider that the proper audience of the consolidated financial statements is only the parent company shareholders; the opponents recognize as interested parties a wider range of users. Baluch et. al. (2010) In other words, the adoption of a specific theory of consolidation is due to the interested parties of the consolidated financial statements. As

businesses internationalized and expanded worldwide the theories which favoured some actors at the expense of others were abandoned. The only one considered the most suitable by IASB and FASB together remained the entity theory which formed the basis for IFRS 3 and FAS 160.

4. Main differences between theories of consolidation

Although over the years, the majority of studies undertaken have discussed the preparation and presentation of consolidated financial statement in relation with two competing theories: the proprietary theory and the entity theory, they were concerns regarding the parent company theory and its extension as well.

Usually, the discussion about which theory is best suited to be used for consolidation purposes were carried around recognition of subsidiary income and reporting net assets of the subsidiary.

The recognition of subsidiary income differs at each theory. The proprietary theory views the company as an extension of its owners. As a result, assets and liabilities of the firm are considered to be those of the owners. In this case, consolidation is made based on a pro rata where the parent consolidates only its proportionate share of a less-than-wholly owned subsidiary's assets, liabilities, revenues and expenses. (Figure no. 1) In the consolidated financial statements, the parent company theory recognizes separately noncontrolling interest's claim on the net assets and earnings of the subsidiary. As Figure no. 2 shows further, a full recognition of subsidiary income takes place only in the entity theory. Because the group is considered to be a single economic entity and managed as such, the consolidated financial statements show the total resources managed by the group, including minority interests. Emphasis is on the consolidated entity itself, with the controlling and noncontrolling shareholders viewed as two separate groups, each having equities in the consolidated entity. According to the entity theory, all assets, liabilities, revenues, and expenses of a less-than-wholly owned subsidiary are included in the consolidated financial statements, with no special treatment accorded either the controlling or noncontrolling interest.

4. Romanian pursuits regarding the theories of consolidation

The evolution of consolidation theories preoccupied the Romanian academics from the accounting field as well. Scrin (2008) analyzes the impact of different consolidation theory on the financial disclosure as well as how they are reflected in the national and international standards. In this respect, each theory is briefly reviewed and critical analyzed, the author mentioning in which

extent the named theory is comprised either in the international standards or in the national accounting law. In addition, Scrin's study comprises critical remarks on the absence of references regarding the consolidation theories in the EU's 7 Directive, replaced nowadays by the 34 Directive issued in 2013. Moreover, to offer a better understanding of every consolidation theory, he offers practical applications on hypothetical consolidated financial statements. The obtained results highlight the difference between the theories discussed, Scrin's opinion supporting the entity theory. (Bogdan et al., 2011)

In accordance with the latest trends focused on empirical models, Müller (2011) conducted an empirical research regarding the value relevance of group financial statements based on the entity versus parent company theory. In this respect, he sets to find out which type of financial statements is more useful for the interested parties: the consolidated financial statements or the individual financial statements of the parent company. Using data of group companies listed on three European stock markets between 2003-2008 Müller developed an empirical model to measure in what extent are connected the share price of the companies with the information provided by the financial statements. The results reject the primacy of the entity theory towards the parent company theory, a joint vision of these two being proposed. Müller's results are consistent to those of Abad et al. (2000) according to which, from the market value relevance, there is no justification for the conceptual adoption of the entity theory by IASB and FASB. As a consequence, one can consider that there is a conflict between the official positions of IASB itself. While in the revised Conceptual Framework adopted in 2010, IASB considers relevance one of the two main characteristics of the financial information, IFRS 3 is still based on the entity theory. But for one to find out how relevant information is, measures are imposed. As latest statistical studies have shown, the relevance of the consolidated financial statements is not justified by the entity theory, reason for which updates should be made in the current reporting rules.

5. Conclusions

Over the years several different theories were developed to serve as basis for consolidated financial statements. As previous studies have shown, choosing to respect a theory instead of another has a significant impact on the information presented in the consolidated financial statements. The difference is more notable especially when the parent company owns less than 100% of the subsidiary's common stock. Because is considered that consolidated financial statements should offer a full perspective of the group as a single economic

entity, IASB used as basis for IFRS 3 the entity theory. Meanwhile, recent empirical studies demonstrated that the adoption of entity theory is not justified by the market value relevance of information presented to the stakeholders. From a legal perspective, because subsidiaries are separate from their parents, the stockholders of the subsidiary have no claim on the parent, respectively on its profits. As a result, stockholders interested on obtaining information regarding the assets, liabilities or income of the individual subsidiaries do not benefit from the consolidated financial statements. Perhaps a better approach of consolidated accounts should focus on aspects specific to both entity theory and parent company theory, as statistical studies conducted (Abad et al., 2000; Müller, 2011) suggested.

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Appendices

Appendix A

Element	Theory					
	Proprietary		Parent Company		Entity	
	Parent's share	Noncontrolling interest's share	Parent's share	Noncontrolling interest's share	Parent's share	Noncontrolling interest's share
Revenues						
Expenses						
Net income						

 Portion included in consolidated financial statements.

Figure No. 1. Recognition of Subsidiary Income

Source: after Baker, R., Christensen, T. & Cottrell, D. (2011). *Essentials of Advanced Financial Accounting*. McGraw-Hill Higher Education.

Appendix B

Element	Theory					
	Proprietary		Parent Company		Entity	
	Parent's share	Noncontrolling interest's share	Parent's share	Noncontrolling interest's share	Parent's share	Noncontrolling interest's share
Goodwill						
Fair value increment						
Book value						

 Portion included in consolidated financial statements.

Figure No. Reporting Net Assets of the Subsidiary

Source: after Baker, R., Christensen, T. & Cottrell, D. (2011). *Essentials of Advanced Financial Accounting*. McGraw-Hill Higher Education.