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Applying the Equity Method as a means of Consolidation in the Public Sector: Experiences in OECD countries

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I Introduction

Changes to the organizational composition of the public sector introduced by New Public Management-style reforms, leading to contracting-out and privatization in their various forms have led to an increased decentralisation of responsibilities in accounting in the public sector. These reforms have not only been done for the reasons of finding adequate forms of organizing public sector activities, but very often the in the German-speaking world used expression “escape out of the budget” was pursued for the purpose of hiding public debt.

It has now become widely accepted by those investigating financial reporting requirements in the public sector, that the consolidated financial statement (CFS) is a useful instrument for governments dealing with publicly-owned entities, because it presents a clear picture of the current economic status and functioning of the whole inter-related Group (Chow et al., 2007; Grossi and Newberry, 2009; Wise, 2010).

As in the private sector, also in the public sector a need for more harmonized accounting practices has arisen among countries. Maybe the best way to reach the aim of more harmonization of financial reports is to follow the International Public Sector Accounting Standards (IPSAS), issued by the International Public Sector Accounting Standards Board (IPSASB), which provide rules for preparing both annual and consolidated financial statements. The IPSAS 6-8 suggest control as the leading criterion to define the scope of consolidation, and by operationalizing it adapt the concept for the specific characteristics of the public sector. With the rising importance of these single public sector accounting standards being used internationally, it can be expected that more and more countries also switch to the respective suggestions for CFS. But is it really this way? This paper therefore aims to answer the following research questions:

1. What is the state of CFS in OECD countries?
2. What consolidation methods are used?
3. Are they influenced in any way by the guiding principles to define the scope of consolidation or by the purpose CFS shall fulfil?

The aim of this paper is to give an overview of actual consolidation practices in OECD countries and to identify major trends in consolidated financial reporting. Therefore, the paper will be structured as follows: section two will give a literature review of different consolidation approaches and the specific needs in the public sector. In section 3, the research-design and terms and concepts of consolidation will be introduced. Section 4 will present findings, which will be summed up in the conclusion, while the floor for further research necessities is opened.

II Literature Review

II.1 Theories of Consolidation

CFSs were created in the private sector to provide information on the financial situation and position of business groups (Walker, 1978). In this realm, CFSs perform a dual function. On the one hand, they are communication tools to external users (financial markets, investors and backers, government, competitive businesses, etc.). On the other hand, they are tools to be used in the planning of activities and in monitoring the impact of group strategies.

Financial statements of the parent company and its subsidiaries are consolidated because CFS give more meaningful information about the entity than each separate entity could do (Kam, 1990) as CFS only show transactions that are made with the surrounding and, therefore, the transactions that are done within the group are eliminated.

There are different theories on how the CFS should be put together:

(i) The Entity Theory focuses both on majority and minority shareholders, which makes the consolidation more complete, relevant, comparable and also more useful than the Parent Company Theory (Aceituno, Valeriano, Bolivar & Pedro, 2006). The group has control over the subsidiary's net assets and the not-controlled interests are seen as a part of the group's equity. The not-controlled interests' part of the result is not seen as a cost for the group, but as a division of the result between two groups of owners

(ii) The Parent Company Theory focuses on the parent company's shareholders when the CFS is established. That means that minority shareholders are seen as outsider interests. Practically the Full Consolidation Method is used. The part of the result that belongs to minority interests is seen as a cost in the financial performance. Further, the equity that belongs to minority interests is seen as a liability in the Parent Company Theory. The Parent Company Theory is used more often than the Entity Theory (Kam, 1990).

(iii) The Ownership Theory focuses only on the part that belongs to the parent company. This means that all assets, liabilities and equity from the parent company are consolidated with the part of assets and liabilities that belongs to the parent company, from its subsidiary's. The non-controlled interest does not belong to the group consolidated financial statement and, therefore, is it not disclosed in the statements. The Proportionate Consolidation excludes outside interest in subsidiaries. This results in that the consolidated financial statement does not tell how much of the equity that belongs to the minority interest (Alfredson*et al.*, 2009).

II.2 Purposes and Useof CFS in the Public Sector

In the public sector, their diffusion reflects the changes in the provision of public services by legally separate entities. These entities often remain totally- or partially-owned by the government. These trends are present in different OECD countries in Europe, as well as in Australia and New Zealand (Torres and Pina, 2005; Grossi and Reichard, 2008). This produces several consequences. On the one hand, this may require these entities to raise resources and account for their use to financial markets. On the other hand, it poses new challenges to governments that are expected to steer and control service providers towards the fulfilment of public interest, to be accountable for the whole basket of services provided (including their financial impacts) and to define comprehensive and consistent fiscal policies (Grossi and Newberry, 2009).

However, due to the formal separation of the annual accounts of the governments and the providers of services, the creation of legally separate government-owned entities has often translated into an actual reduction in the degree of accountability and decision usefulness of public sector accounts. In fact, the annual accounts of governments may disclose only a partial view of their economic and financial activities, because the financial situations and results of subsidiaries, joint ventures and associates are not necessarily included in the traditional annual reports of the government.

Internal and external users of financial information are not able to base their decisions on reliable and relevant information about the financial position, financial performance and cash flows of the “whole” government or they may find it more difficult to form an idea on it. Indeed, it must be recognized that CFSs, are not mutually exclusive of financial statements or financial information of other kinds. However, this might translate into more fragmented information. In order to avoid this lack of information, CFSs have often been presented as a necessary step (Lande, 1998; Heald and Georgiou, 2000; Grossi and Mussari, 2008).

The politicians and public managers consider the CFS as a useful tool for steering and controlling the direct and indirect provision of public services. It is a fundamental tool for public decision-making in programming and controlling the different public policies.

The CFS is also very useful for external stakeholders (e.g. citizens, voters, taxpayers, suppliers, other public administrations, banks and rating agencies). Since the compilation of the CFS helps to give a true and fair view of the whole situation of the Government and its publicly-owned corporations, accountability is improved. In particular banks are interested in the CFS to understand the real and effective opportunities of creditworthiness of the governments and their owned corporations. Moreover, the CFS could be a useful, as informative tool for rating agencies to determine the solvency and the risks.

The CFS in the public sector should provide an overview of the financial performance and position not only of the single government but of the whole group of organizations which are under its control and provide public services. (Broadbent *et al*., 1996; Chan, 2003; Chow et al., 2007; Wise, 2006; Wise, 2010). However there are some problems with using CFS in the public sector, including the difficulty of comparing consolidated information across different levels of government and defining the scope of consolidation (Heald and Georgiu, 2000; Robb and Newberry, 2007; Grossi and Pepe, 2009).

III Research Design and Consolidation Methods and Concepts used

This paper seeks to give an overview of consolidation practices in OECD countries. The main focus of this analysis build 13 OECD member states which follow an accrual basis of accounting (e.g. IPSAS or comparable National Accounting Standards) and currently compile (and present) consolidated financial statements or will conduct similar reforms in the near future. These countries have been analyzed in detail. Another group of ten countries – which either follow the cash basis of accounting and/or do not compile a CFS – have complementarily been analyzed to abstract the general OECD practice. Figure 1 presents the research scope in detail:

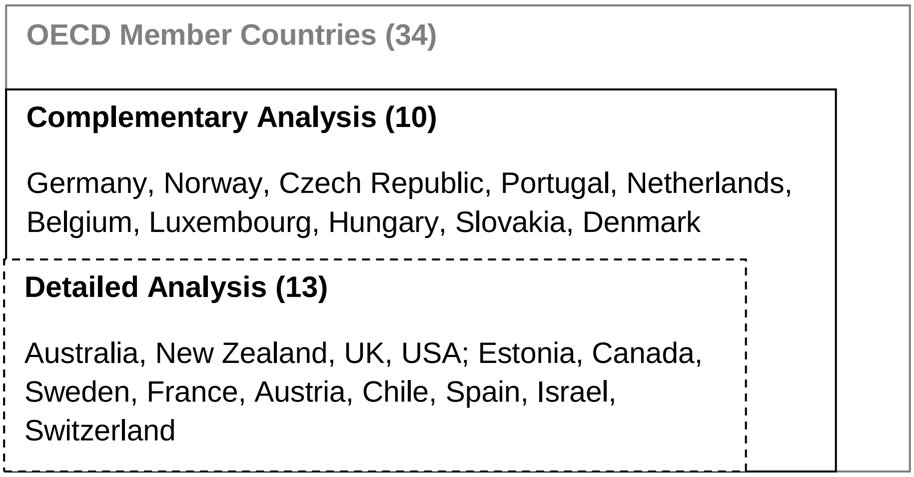

Figure 1: Assessment Framework

The findings are based on the comparison of the different consolidation standards and other legal requirements as well as the published financial statements of the 23 OECD member countries taking the IPSAS as a benchmark. For each country which has been analysed in detail the findings were completed and validated through semi-structured interviews with public finance experts of the respective OECD country. These interviews have been complemented by a brief survey of the rest of the OECD countries based on a structured questionnaire whereat the above mentioned ten countries responded to.

III.1 Consolidation Methodsversus Technical Aggregation

Differing to the IPSAS, in this paper the term consolidated financial statements is used in the meaning of financial statements being compiled on basis of accrual accounting, using the methods of international accounting standards according to consolidation, including full consolidation (or line-by-line consolidation), the equity method of consolidation and/or proportional consolidation. In this respect, the methods correspond to international accounting standards with the following meaning:

(i) **Line-by-line consolidation / full consolidation:** the financial statements of a controlling entity and its controlled entities are presented as if they were single financial statements by combining identical or similar items of assets, liabilities, net assets/equity, revenue and expenses on a line-by-line basis. The underlying financial statements shall be compiled on the basis of the same underlying accounting standards and with the same date. Transactions between the entities are being eliminated and minority interests are identified and presented separately.

(ii) **Equity method:** the shares of an entity are initially recognized at cost and subsequently adjusted for the post-acquisition change in the reporting entity’s share of net assets/ equity of the entity.

(iii) **Proportional consolidation:** a partner’s share of each of the assets, liabilities, revenue and expenses of a jointly controlled entity is combined line by line with similar items in the partner’s financial statements or reported as separate line items in the partner’s financial statements (method for joint ventures).

Contrasting to these methods, more traditional approaches towards technically compiled single financial statements of an economic entity are often based on the (modified) cash principle. These aggregations are used for a consolidated presentation of budgets whilst unsystematic or totally missing eliminations of transactions lead to intransparent totals. Such approaches towards aggregation are not used in the meaning of consolidated financial statements in this paper.

III.2 Perspectives for Defining the Scope of Consolidation

The composition of CFS could be based on the following perspectives to define the scope of consolidation (Bergmann, 2009):

(i) Economical perspective (control): CFS on the basis of the economic perspective encompasses the economic entity, so to say the controlling entity and all entities being controlled by it. The economical perspective comprises the following two criteria:

- power element of control
- benefit element of control; benefit also includes non-financial components (e.g. public service provision).

The application of the economical perspective leads to a relatively large scope of consolidation. Political aspects of defining the boundaries of the public sector are not being taken into account.

(ii) Budgetary perspective: according to the budgetary perspective, entities should be consolidated if they are relevant for the budget or budgetary decisions are influential or even critical for them. The budgetary perspective includes the control principle, but is adopting it in a more rigorous way as it requires budgetary influence. Therefore the scope of consolidation is smaller and excludes entities that are neither receiving funds from the government budgets nor contributing to it.

(iii) Organisational and legal perspective: CFS following the organisation perspective would include all entities that - according to organisational law – are part of the entity.

(iv) Statistical perspective: CFS on the basis of financial statistics follows the definition of the so-called general government sector (GGS). GGS exclude entities with more than 50% market revenue. Control is no prerequisite. GGS includes all levels of government, even in a federal setting where states are clearly not controlled by the national government.

(v) Risk perspective: Adopting the risk perspective would lead to a scope of consolidation comprising all entities that could cause financial risk to a government. This is a very large group of entities and would be at least as large as with the economic perspective, as it would also include such big corporations where governments would need to step in in case of trouble as they are deemed to be “too big to fail”. The control criterion is no prerequisite.

IV Research Findings

IV.1 Overview and development trends

For the sake of some better overview of consolidation practices in OECD countries, the countries analysed were grouped according to selected criteria, being lined out in the following table:

	State of financial accounting and reporting
Group 1	Accrual accounting implemented; consolidated financial statements in use
Group 2	In the process of changing from cash to accruals; orientation towards international public sector accounting standards; at the moment no consolidated financial statements, but implementation plans for them in the near future (short- or mid-term)
Group 3	Accrual accounting implemented; no consolidated financial statements at the moment; no plans for such statements
Group 4	Cash accounting; no plans to change to accrual accounting; no consolidated financial statements at the moment; no plans for such statements in the near future

Table 1: Country cluster description

The table above presents the main development trends in consolidation practices in OECD countries. They can be summarized as follows:

1) For the OECD countries, a trend towards accrual accounting and presentation of consolidated financial statements according to international accounting standards is obvious. A remarkable number of countries - the so-called “pioneers” - has implemented accrual accounting and presents consolidated financial statements. They follow the approach of eliminating internal transactions, the disclosure of minority interests or audit of CFS. In reference to criteria of consolidation and methods, different practices can be found, ranging from UK’s Whole-of-Government-approach following the control-criterion, to the Swedish example of consolidation of controlled entities applying the equity method on the basis of organisational law. This makes a general judgement more difficult. Nevertheless, countries which are explicitly following international accounting standards, like Australia, New Zealand, Canada, United Kingdom, Estonia and, in the near future, Spain and Chile, seem to be clearly oriented towards the control-criterion. Countries with a looser link to international standards by tendency show a scope of consolidation which can rather be explained by historical developments or which has been defined later on (e.g. USA, Sweden, and Denmark) and therefore lacks the stringency and taxonomy that it would have following accounting standards.

2) A second group of countries (e.g. Austria, Belgium), the “reform followers”, is reforming national accounting standards at the moment or will be doing so in the near future. The implementation of accrual accounting according to IPSAS or IFRS, as well as the presentation of consolidated financial statements is at the heart of these reforms. These countries therefore follow the group of pioneering countries mentioned above and with them, the trend of modern, transparent public sector financial statements.

3) Recent practice of OECD countries shows a correlation between the accounting method (cash or accrual) and the presentation of consolidated financial statements. For countries with accrual accounting the presentation of consolidated financial statements is more or less state of the art. Except Hungary, all countries with accrual accounting compile consolidated financial statements, or at least plan to do so, whilst countries on a cash basis typically present aggregated statements of income and expenditure (especially as part of budget execution reporting), but no consolidated financial statements as suggested by international accounting standards.

4) A last group of countries – the so-called reform refusers – are not open towards international developments and defy any attempts towards accrual accounting

reforms, sticking to the cash principle. At a closer look, with Norway, the Netherlands, Germany and Luxembourg, rather prosperous countries are part of the group, and the switch to accrual accounting is either politically contested or failed as in the case of Germany, or the pressures on the financial system and performance are simply not high enough. On the other hand, in Norway, Germany and the Netherlands, the systems on subnational levels are significantly further developed than at the national level.

Nevertheless, the recent developments in OECD countries or discussions at Eurostat concerning the compulsory implementation of IPSAS for the countries of the European Union demonstrate that also most of the countries of the last group sooner or later have to address the topic of accrual accounting.

IV.2 Benefit and use of consolidated financial statements

The survey identified different users of CFS in the single countries, but doesn't focus on the possible benefits or the expectations of different user groups. The main reason for this is the absence of systematic user surveys where such information could be extracted from, at least in the context of public organisations compiling CFS, while in academia, there has been some, though not too much research on this topic (e.g. Wise, 2010, for Australia).

New Zealand is the only exception, where recently a survey was conducted on behalf of the Treasury comprising around 30 interviews with representatives of the most important user groups (industries, economy, science, politics, financial institutions, media, as well as international organisations). The aim of the survey is reflecting on the current form of financial reporting to better align it with user needs. Unfortunately, CFS is not treated in detail, but only as part of financial statements. In summary, it can be stated that financial reporting contains useful information, therefore generating benefit to users. Special highlights were given exceptional willingness towards high transparency, high data quality, as well as detailed data preparation and presentation. Extensive documentation of information sends important signals to national and international stakeholders regarding transparent reporting, being the basis of satisfying heterogeneous information needs.

IV.3 Synthesis

The analysis of consolidation methods and scope leads us to three main statements:

The Whole-of-Government approach as implemented in the UK or Estonia, can be seen as the most consequent approach to CFS for countries with either a centralised state architecture or which have experienced it traditionally, like in the case of the UK. Whole-of-Government means that consolidation comprises all state levels.[1]The case of Estonia seems to be especially remarkable as both the National Bank, as well as other entities with a strong balance sheet are consolidated at the highest level, with two CFS reflecting on the one side the public sector without public enterprises and financial institutions (General Government Sector) and on the other side the total of the public sector with all controlled entities.

For federal states the Whole-of-Government approach is less useful because of their state architecture. For this group of states, a clear tendency towards full consolidation following the control criterion is obvious. The group is made up of the Anglo-American states, traditionally being innovative regarding financial management, but also Spain, of which this would be less expected. Regarding the consolidation of entities with a strong balance sheet, namely commercial banks and insurances, even countries generally following full consolidation due to the control criterion use the equity method (e.g. Spain or – still, tough this will change – UK regarding commercial banks). While Canada follows the control criterion to define the scope

[1]Though Australia also uses the term WOG, the independent sub-national levels of government are not being consolidated.

of consolidation, financially independent (though economically controlled) enterprises are being consolidated applying the equity method. A slightly deviating path from the control criterion is followed by the United States, where financial accountability, as well as historical, organic developments define the scope of consolidation.

A third cluster is made up by those states that currently are strongly oriented towards the equity method, either as an intermediate step towards full consolidation (like in Austria or in Chile) or as a consolidation method planned in the medium term, like in Sweden or Switzerland, where organisational criteria dominate the definition of the scope of consolidation and controlled entities being consolidated applying the equity method.
In the following figure the countries have been arranged according to their position against the axes of scope and method of consolidation (y) and implementation of CFS (x).

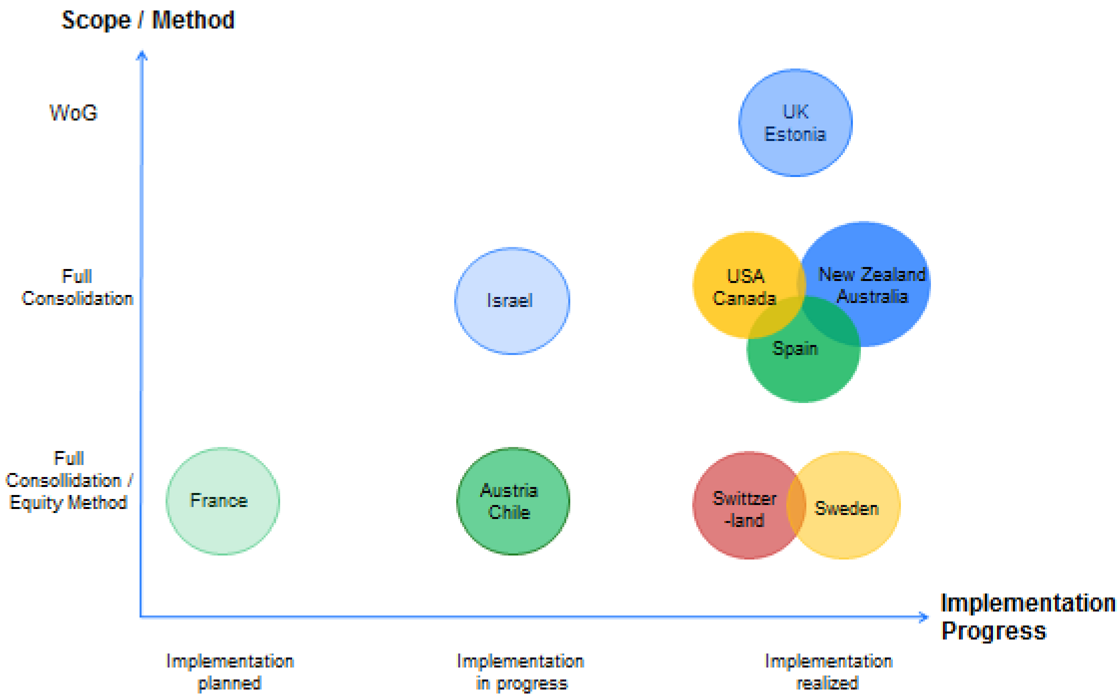

Figure 2: Consolidation methods and implementation process

V Conclusion

CFS and the information presented form a neuralgic interface between different economical perspectives, between different systems and different user groups. They link micro- (financial accounting) and macro-perspectives (statistical perspective) on the public sector and potentially present information for management decision on the one hand and for financial and fiscal policy decisions on the other hand. These considerations were of importance at the early implementation stages of WoG in the UK at least in the beginning, though a more pragmatic approach was followed in later stages (Heald/Georgiou, 2009; 2011; Chow/Humphrey/Moll, 2009) and have shaped the Australian WoG approach. As not all countries presenting CFS follow that kind of textbook-like design, the papers closes with some answers on the three research questions presented at the beginning.

V.1 Status of Consolidation Practice in OECD countries

CFS is state of the art and in financial reporting and an essential element of public sector financial statements in OECD countries with modern financial management systems. Experiences with CFS on an accrual basis range back as far as into the early 90ies of the last century in the Anglo-American countries New Zealand and Australia. While the reasons for implementation are very different (i.e. macro-economic perspectives; full micro-economic perspective; harmonization of financial accounting with financial statistics), it can be stated that the topic gains importance with the increasing use of internationally comparable GAAP and today, is a building block of modern financial management. This trend is being followed by countries that had followed more traditional approaches of aggregation up until now (i.e. France, Austria, Spain or Chile). The only user survey available, dating from 2012 and conducted in New Zealand, sketches a positive picture of CFS. Users of CFS appreciate its rich information (transparency, data quality and detailing). Some users also criticize high complexity which is hardly avoidable, however.

V.II Scope of consolidation and consolidation methods

In most OECD countries examined the control criterion is the dominant principle to define the scope of consolidation. This is even true in the light of most of these countries orienting themselves or even fully implementing the IPSASs. Even New Zealand, which is using sector neutral accounting standards, is going to follow the IPSAS in respect to consolidation starting with the budget year 2014/15.The different ways to operationalize the term “control” show, however, that the concept, originating from private sector accounting standards, has to be adapted by public sector institutions, therefore reflecting national characteristics to a certain degree.

Deviating from the control criterion, in the US financial accountability, stewardship and control of financially dominated entities are the leading principles to define the scope of consolidation. In Sweden, the organisational perspective is followed. Both approaches share the fact of dealing with this issue more on an individual basis, than showing the rigour of the control criterion, which could also be seen as the negative effect of the organisational perspective.

Concerning the consolidation of national banks and social insurance companies, research findings give a mixed picture. Those countries which are clearly oriented towards international accounting standards, by tendency consolidate both the national bank, as well as social security (i.e. New Zealand, Australia, Estonia, UK – where the consolidation of the national bank is at least planned for the near future, Canada – applying the modified equity method). Because of the early stage of accrual accounting reforms, Austria and France at the moment neither consolidate national banks, nor social security institutions. For all other countries, no general statements can be made. However, concerning national banks, the two conflicting criteria of economical control and statutory independence from executive and legislative bodies have brought up different solutions, namely either consolidation (like in the countries stated above), or to separate presentation outside CFS (i.e. US, Chile). From the countries examined, only in the USA and in Switzerland, the national government is not owner of the national bank.

Even if the control criterion is the dominant criterion to define the scope of consolidation, this does not necessarily mean that all entities controlled are also fully consolidated. In specific cases, it seems to be reasonable to favour the equity method instead of full consolidation.

When arguing in favour of the equity method, it is stated that shares are presented as individual asset items, and therefore more transparent, as if all items would be added up, like in the case of full consolidation. This could lead to a blurred picture on central government.

Therefore, in many countries entities with a strong balance sheet, gaining significant revenues from market activities (mainly commercial banks and financial intermediates), are not fully consolidated, but consolidated according to the equity method. However, consolidation by the equity method doesn't lead to a clear picture concerning liabilities and the respective financial risk associated with controlled entities.

Canada presents an interesting example, as it also follows statistical considerations besides the dominating criterion of control. Financially independent, but economically controlled companies are not fully consolidated, the reason for which is the fact that the activities of the companies have commercial character no matter whether they are controlled by the government or not. The relationship between government and companies therefore resembles more an investment, which is better reflected in financial statements using the equity method.

To conclude, it can be argued that although, with the spread of international accounting standards, control is the dominant criterion in public sector CFS, resulting full consolidation is not satisfying information needs in the meaning that the full consolidation of entities with large balance sheets is blurring the picture. This is especially true for financial companies. In any of the examined cases, the equity method is used instead of full consolidation. As argued, this has disadvantages in the sense of limited information concerning liabilities, though.

From the perspective of clear information about the financial performance and position of a government, the best approach would be different CFS showing different perimeters of consolidation. This would start with CFS for the central government, where all separate financial statements of single entities, e.g. ministries, are consolidated to show the financial situation of central government. Within separate financial statements, IPSAS 6 suggests three methods to account for investments in controlled entities (equity, cost or fair value), of which the equity method is the most applicable. On the level of quasi-government, further controlled entities (e.g. public companies) would be consolidation to the consolidated statement of central government to show the full picture of financial information.

As the discussion with international standard setters on the topic of equity consolidation or full consolidation goes on, it will be interesting to further observe discussions and developments.

In the light of the current crisis, however, any approach, being either full consolidation or equity consolidation, would have given a better and clearer information basis for those governments switching to a risk perspective overnight in an attempt to save their financial sectors under risk.

This research was conducted on behalf of the Swiss Federal Government. The paper only gives a summary of the results. For any further details concerning the countries examined, please contact the authors.

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