Consolidation theories and push-down accounting: achieving global convergence

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ABSTRACT

This paper examines the parent, entity, and traditional theories of consolidation with a focus on the relevance and representational faithfulness of the information each provides to decision makers. In addition, push-down accounting procedures are examined to determine if they can be used to eliminate the complexity of the consolidation process. Finally, FAS 141R, FAS 160, and International Financial Reporting Standards for business combinations are evaluated and revisions recommended to achieve global convergence in this area.

Keywords: consolidation theory, push-down accounting, global convergence

INTRODUCTION

On December 15, 2008, Statement of Financial Accounting Standards 141R (FAS 141R) became the applicable standard for all business combinations (FASB, 2007a). This standard superseded FAS 141 (FASB, 2001), which was issued in 2001, and intended to move U.S. consolidation procedures towards the international standards and concepts of fair value reporting (O'Bryan & Keen, 2009, p. 1).

Methods of accounting for business combinations have been debated for decades. Prior to FAS 141, APB Opinion No. 16 provided the guidelines for accounting for business combinations. Under these guidelines, a business combination was considered to be either a purchase or a pooling of interests. With the issuance of FAS 141, the pooling of interests method was abolished and the purchase method became the preferred methodology of accounting for business combinations. Today, as companies begin to adopt FAS 141R, these transactions will be reported using the acquisition method.

Both FASB and IASB concluded that the acquisition method was the most appropriate method for accounting for business combinations on the basis that the model best reflects how entities acquire assets or assume liabilities, producing information that is comparable to other accounting information (Silliman, 2008, p. 36). Differences in opinion on the application of this method over the years have led to the evolution of three theories on how controlling and non-controlling interests should be measured and disclosed in financial statements: parent company theory, entity theory, and a hybrid of the called traditional theory. Over the years, the authoritative accounting bodies have made numerous modifications to consolidation policies and procedures. Exhibit 1 shows the evolution of these policies (Beams et al, 2009).

PURPOSE

This paper examines the parent, entity, and traditional theories with a focus on the relevance and representational faithfulness of the information each provides to decision makers. In addition, push-down accounting procedures are examined to determine if they can be used to eliminate the complexity of the consolidation process. Finally, FAS 141R, FAS 160, and International Financial Reporting Standards on business combinations are evaluated and revisions recommended achieving global convergence in this area.

CONSOLIDATION THEORIES

The evolution of the consolidation parent, entity, and traditional/hybrid theories of consolidation is outlined below.

Parent Company Theory

This theory assumes that consolidated financial statements are an extension of parent company statements and should be prepared from the viewpoint of the parent company stockholders (Beams, et al, 2009). Advocates of this theory believe that consolidated financial statements do not provide any value to the non-controlling stockholders of the acquired subsidiary.

Exhibit 1. Evolution of Accounting for Business Combinations (FASB, 2007b):

- 1944: American Accounting Association publishes "The Entity Theory of Consolidated Statements" by Professor Maurice Moonitz. Consolidation focus is the total business entity.

- 1959: ARB No. 51 is published - Consolidated Financial Statements. Consolidation focus is a hybrid between parent only and total business entity theories. Describes an ambiguous definition of control and therefore is not definitive under which circumstances consolidation is necessary. Led to the evolution of the traditional theory used in consolidation procedures.

- 1970: APB Opinion 16 is published - Business Combinations. Dictated business combinations be accounted for using one of two methods, the pooling-of-interests method or the purchase method. The consolidation focus is the parent with the traditional or hybrid approach used in its implementation.

- 1987: FAS 94 is issued - Consolidation of All Majority-Owned Subsidiaries. Amends ARB No. 51 to require consolidation of all majority-owned subsidiaries unless control is temporary or does not rest with the majority owner. Focuses on the traditional hybrid accounting approach.

- 2001: FAS 141 is issued - Business Combinations. Requires all business combinations be accounted for using the purchase method. Recommends continued use of the traditional/hybrid method of implementation.

- 2007: FAS 141R is issued - Business Combinations. Replaces FAS 141 and requires the acquisition method of accounting be used for business combinations. Also, prescribes the identification of an acquirer for each business combination. Uses the entity theory and fair value measurements for implementation.

- 2007: FAS 160 is issued – Non-controlling Interests in Consolidated Financial Statements. Amends ARB 51 to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Uses the entity theory and fair value measurements for implementation.

The parent company theory has unique characteristics in the way certain elements of the consolidated financial statements are disclosed when a non-controlling interest is present. When net income for the consolidated entity is reported, the parent company theory only takes into account the parent company's share of subsidiary income. If a non-controlling interest exists, the non-controlling interest share of net income is deemed to be an expense. The non-controlling interest in the subsidiary is reported as a liability on the consolidated financial statements. Unrealized gains and losses from upstream sales are eliminated to the extent of the parent company's ownership percentage in the subsidiary (Davis and Largay, 2008).

The existence of a non-controlling interest also impacts the way the assets acquired in the business combination are presented in consolidated financial statements. While the parent company theory uses fair values of the acquired assets and liabilities, the theory is implemented using a hybrid approach to reporting the fair values. Thus, the parent-company theory initially consolidates subsidiary assets at their book values, plus the parent company's share of any excess fair value over book values. However, the non-controlling interest share of net assets is not adjusted to reflect their share of the excess between fair value and book value (Davis and Largay, 2008).

While this theory may be appropriate to use when the parent company acquires 100% of the subsidiary, the information it provides loses relevance when a non-controlling interest is present. First, shareholder interests, whether controlling or non-controlling, are not liabilities under any of the accepted concepts of a liability, and income to shareholders does not meet the requirements for expense recognition. Another weakness is that the amount of acquired assets and liabilities reported in the consolidated financial statements falls short of fair value reporting. Although this approach reflects the cost principle from the viewpoint of the parent company, it leads to inconsistent treatment of controlling and non-controlling interests in the consolidated financial statements and to a balance sheet valuation that reflects neither historical cost nor fair value. Two other theories sought to improve on these weaknesses as accounting applications of the acquisition method of business combinations evolved (Chen and Chen, 2009).

Contemporary/Entity Theory

The contemporary/entity theory differs from the parent-company theory in that the consolidated financial statements prepared under this approach take into account the total entity created by the parent company and the subsidiary. This theory creates consolidated financial statements that will provide value to various groups including the parent company shareholders, non-controlling shareholders of the subsidiary, and creditors. Under the entity theory, the controlling shareholders, non-controlling shareholders, and consolidated entity are considered equal, with no preference or emphasis given to group (Beams, et al, 2009).

The reporting of consolidated net income under the entity theory includes total net income of the parent company and the subsidiary and then allocates the controlling and non-controlling share of subsidiary net income accordingly. The non-controlling interest in the subsidiary is designated by a separate line item in the stockholders' equity section of the consolidated balance sheet. In the case of unrealized gains and losses from upstream sales, the total unrealized gain or loss is eliminated. The amount eliminated is then assigned to income to non-controlling and controlling stockholders according to their respective ownership percentages (Walsh, 2006-7).

There are additional differences between the parent company theory and the entity theory in the manner in which assets of the subsidiary are valued. The entity theory consolidates subsidiary assets and liabilities at their fair values, and it accounts for the controlling and non-controlling interests in those net assets consistently. The fair value of the subsidiary's assets is derived from the purchase price paid for a given percentage of ownership in the subsidiary (Walsh, 2006-7).

While the entity theory provides more relevant and representationally faithful information to decision makers when compared to the parent company theory, there are critics who believe that the price paid by the parent company for its controlling interest is not a valid basis for valuation of non-controlling interests (Chen and Chen, 2009). This is due to the fact that once the parent is able to exercise absolute control over the subsidiary, the shares held by non-controlling stockholders do not represent equity ownership in the usual sense.

Both the U.S. and global standards require that the non-controlling interest be separately valued at acquisition. However, such valuations and separate determinations of non-controlling goodwill are next to impossible. Thus, both the FASB and the IASB allowed for non-controlling interest to be imputed from the price paid for the controlling interest. As companies implement FAS 141R, it is clear that imputing non-controlling interest is the preferred measurement approach because it is practical and derives its measure from a FAS 157 Level 1 evidence, that is, an arms-length market transaction. However, it must be considered that an investor may be willing to pay a premium price for the rights to control an investee, but not be willing to purchase the remaining stock, the non-controlling portion, at that same inflated price. The non-controlling portion does not have the added value of the right to control, and therefore, measuring the equity of non-controlling shareholders using the controlling price paid overstates the value of the non-controlling interest. A hybrid of contemporary/entity and parent company theories evolved to help address this issue (Wendell, 2008).

Traditional/Hybrid Theory

The traditional theory of consolidation incorporates characteristics of the parent company theory and the contemporary/entity theory. The consolidated statements prepared using the traditional theory are intended to benefit the parent company shareholders, as is the case with the parent company theory, and a wider audience that includes the parent company's creditors. However, the non-controlling interest of the subsidiary that is highlighted by the entity theory is still lost (Beams, et al, 2009).

The traditional theory improves on the parent company theory's accounting for the non-controlling interest. While the traditional theory calculates consolidated net income using a similar process as used in the parent company theory, it avoids reporting the non-controlling interest as an expense and a liability. The preferred accounting practices under traditional theory report non-controlling interest as a reduction of consolidated net income and an increase to equity that is essentially a wash to overall equity (Davis and Largay, 2008).

The traditional theory also implements characteristics of both parent company theory and entity theory in its approach to valuing assets of the acquired subsidiary and the elimination of unrealized gains and losses from upstream sales. When the assets of the acquired subsidiary are consolidated, the traditional theory follows the same process as the parent company theory and consolidates subsidiary assets at their book values, plus the parent company's share of any excess fair value over book values. However, elimination of unrealized gains and losses arising from upstream sales under the traditional theory follows a process similar to that used under the entity theory (Chen and Chen, 2009).

Rationale for Multiple Theories of Consolidation

The primary reason why multiple theories of consolidation have evolved is due to the nature of identifying the appropriate audience for the consolidated financial statements. There are those who believe that the consolidated financial statement should benefit the parent company shareholders only and the parent company theory of consolidation caters to this group. In contrast, the entity theory acknowledges a broader group of financial statement users including creditors, non-controlling interests, and the parent company shareholders. The traditional theory scales back the financial statement audience to emphasize the parent company shareholders and creditors. Among the multiple theories of consolidation, the entity theory is the only approach that emphasizes non-controlling interests.

With the issuance of FAS 160 conveying the importance of reporting the non-controlling interest in a business combination, the entity theory of consolidation has become the standard for reporting business combinations under the acquisition method. Both FAS 141R and FAS 160 require a number of complex measurements and disclosures related to the reporting of a non-controlling interest in a subsidiary including: (1) ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within the equity section; and (2) the amount of consolidated net income attributable to the parent and to the non-controlling interest be clearly identified and presented on the face of the consolidated statement of income. To combat the complexities of these measurements, push-down accounting procedures were developed and are described in the next section (Rosen and Grossman, 1998).

PUSH-DOWN ACCOUNTING

Push-down accounting affects the books of the subsidiary and its separate financial statements, but does not alter consolidated financial statements, simplifying the consolidation process (Thomas & Hagler, 1988). Instead of recording the investment in the subsidiary on the parent's books and allocating the purchase price of identifiable assets, liabilities and goodwill through working paper adjusting entries, the allocation of the purchase price may be recorded in the subsidiary's accounts, thereby pushing the purchase price down into the subsidiary's records. The financial statements of the subsidiary report the cost incurred by the parent company in buying the subsidiary instead of the subsidiary's historical costs.

The SEC requires push-down accounting for SEC filings when a subsidiary is substantially wholly owned (approximately 97% or more ownership) with no publicly held debt or preferred stock outstanding (Colley and Volkan, 1988). The SEC argues that when the parent controls the form of ownership of an entity, the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent's operations. However, when a subsidiary has outstanding public debt or preferred stock, or when a significant non-controlling interest exists, the parent company may not be able to control the form of ownership. In these cases, the SEC encourages push-down accounting, but does not require it (Colley and Volkan, 1988).

There are some basic procedures involved in the application of push-down accounting during the year of purchase. A new paid-in capital account is created, named push-down capital. When the parent company acquires a controlling interest the subsidiary, regardless of the percentage, the retained earnings of the subsidiary is moved into the new push-down capital account, removing the retained earnings of the subsidiary from the books. Another step in the push-down procedures involves revaluing the net assets and goodwill of the subsidiary to reflect the purchase price paid by the parent (Beams, et al, 2009).

Use of Push-Down Accounting: Challenges and Opportunities

Push-down accounting can be used to measure and report subsidiary income reflecting the fair values used to finalize the exchange transaction when control of assets and liabilities is transferred from the subsidiary company to the parent company. The exchange values are determined in an arms-length transaction among market participants resulting in evidence that has the highest degree of credibility. While it is important to note that both the U.S. and international standards do not accept push-down accounting, the procedures involved have merit and may be included in future revisions of the existing standards (Smith and Saemann, 2007).

Push-down accounting is controversial only when separate-company statements of the subsidiary are issued to non-controlling interests, creditors, and other interested parties. Detractors believe that push-down accounting is a violation of the entity concept and historical cost principles (Colley and Volkan, 1988). Transactions of the entity's shareholders are not transactions of the entity and should not affect the entity's accounting. Likewise, a change in the subsidiary's ownership does not establish a new accounting basis in its financial statements and, subsequently, does not justify a restatement of the subsidiary's assets and liabilities. Proponents counter that the price paid for an entity when there is a substantial change in ownership is the most relevant basis for measuring the subsidiary's assets, liabilities, and results of operations from the perspective of the owners (Thomas & Hagler, 1988), and use of historical cost in this case lacks relevance and representational faithfulness.

Another criticism of push-down accounting is that it impairs the consistency in comparable financial statement data, potentially misleading lenders and non-controlling ownership interests that rely on comparable data for their own evaluation (Moore, 1988). Proponents counter that the data becomes more relevant by accounting for substance over form; thus, the data provided to users of the subsidiary's financial statements would provide representationally faithful measures of performance and financial standing.

Some critics contend that push-down accounting minimizes net income when assets with inflated costs are expensed (Rosen and Grossman, 1998). Decline in the price earnings ratio and dividend declarations may follow. However, reported consolidated values remain relevant and representationally faithful.

Issues with taxing authorities, particularly at the state level, could arise with the use of push-down accounting. Some states use the value of a corporation's capital stock as its tax base; thus, an increase to a subsidiary's net assets due to the application of push-down accounting could result in a higher tax base and lead the subsidiary to exclude this increase from the computation of its tax base (Rosen & Grossman, 1998). However, adjusting asset bases for financial reporting does not mean that the same bases will be used for tax reporting.

Push-down accounting has not been consistently applied amongst its proponents. The available authoritative guidance favors the use of push-down accounting if a subsidiary is owned 90% or more, prohibits its use for less than 50% ownership, and is silent if ownership is in the 50% to 90% range. An argument can be made that once an ownership of more than 50% exists, the non-controlling shareholders are no longer owners, per se, but resemble investors instead; suggesting the use of push-down accounting be used when ownership exceeds 50% (Colley & Volkan, 1988; Beams, et al, 2009).

In addition, a general lack of authoritative literature exists as to how push-down allocations should be done when less than a 100% ownership exists. Since FAS 141R and FAS 160 has embraced the entity theory, an argument can be made that the economic substance of the transaction requires imputing total values, because a proportional revaluation results in a consolidation where the controlling amounts are revalued, while the non-controlling amounts are not. The FASB's current study of consolidations and the equity method includes push-down accounting. The use of push-down accounting under the entity theory produces subsidiary income equivalent to the income derived from more complex and lengthy consolidation procedures currently in use (Beams, et al, 2009). Thus, push-down accounting under the entity theory results in a one-line consolidation in the truest sense since using simple procedures it produces measures equivalent to those obtained under the complex procedures presently used.

FASB AND IASB PRIORITIES IN ISSUING FAS 141R &160 AND IFRS 3: GLOBAL CONVERGENCE OPPORTUNITIES

The FASB's main objective in the issuance of FAS 141R and FAS 160 was to improve the information reported about a business combination and to achieve global convergence with the IASB and IFRS 3 (IASB, 2008). The FASB worked closely with the IASB to promote international convergence of accounting standards. Exhibit 2 summarizes the major differences between FAS 141 and FAS 141R. The items that require further revisions to achieve global convergence are indicated with (*) and discussed next.

Contingent consideration

A company often agrees to pay additional payments to the seller of a business based on the outcome of future results. When firms do not recognize these contingent considerations until the event occurs, managers are not held accountable for what they negotiated. FAS 141R requires companies to measure and record these contingent considerations at their estimated fair value at the time of sale. One must note the counterintuitive result of this requirement since a company that does not meet its targets will record a gain by means of reducing the contingent liability essentially reversing the expense previously recorded when the contingency was established. As a result, contingent consideration arrangements may eventually become less prevalent due to the financial statement volatility that may result from these agreements.

Exhibit 2. Major Differences between FAS 141 and FAS 141R:

	Current GAAP	New Standard
Acquisition Expenses	Capitalized	Expensed
In-Progress R&D (*)	Expensed	Capitalized
Bargain Purchase Gain	Negative Goodwill: Pro rata reduction of particular assets	Ordinary gain on the income statement
Goodwill Measurement (*)	Calculated as the excess of investment cost over acquirer's proportionate share of net identifiable	Calculated as the excess of the consideration transferred plus the fair value of any non-controlling interest over the fair values of net identifiable assets
Contingent Considerations/ Contingencies (*)	Recorded as part of the cost of the combination only if the contingency is determinable at the date of acquisition	Recognized at estimated fair value on acquisition date. Acquirer estimates the fair value of the contingencies
Step Acquisitions	Once control is achieved, each investment layer's book value is used to determine the total investment cost	Once control is achieved, each investment layer is re-measured at fair value on acquisition date
Disclosures	Limited to describing the acquisition's impact on reported earnings and the allocation of the purchase price to acquired net assets	Extensive disclosures enabling the users of the financial statements to evaluate the nature and financial effects of the business combination
Measurement Period	The provisional amounts must be adjusted for up to one year after the acquisition. No clear guidance whether the changes are reported as current income or treated retroactively	The measurement period shall not exceed one year. During that period the acquirer restates comparative statements if the revised amounts had been known on the date of the acquisition

Contingencies:

FAS 141(R) requires that contractual contingent assets and liabilities be recognized at their fair value on the date of acquisition. Non-contractual contingencies must be recorded at their fair value if it is more likely than not than an asset or liability exists. Requiring accountants to recognize contingencies on the date of acquisition may increase transparency in the financial statements. However, contingencies are difficult to measure because they are based on the outcome of future events. Replacing the FAS 5 standard of probable (likely to occur) with a standard of more likely than not raised objections to date. IFRS 3 allows use of the more conservative FAS 5 criteria to record such amounts.

Accounting for goodwill and non-controlling interest:

The amount of goodwill continues to be measured as a residual cost under FAS 141R. It is calculated as the excess of consideration transferred plus the fair value of any non-controlling interest in the acquired business at the acquisition date, less the fair values of the identifiable net assets acquired. Some accounting professionals criticize the decision to use the entire fair value of the non-controlling interest in the acquired business when calculating goodwill. Under FAS 141R, the entire portion of non-controlling interest must be measured at fair value. Under the IFRS 3, non-controlling interest may be measured at its proportionate share of the identifiable net assets rather than at the full fair value.

Accounting for in-progress R&D costs:

FAS 141R supersedes some of the procedures included in the FAS 142 which requires research and development (R&D) assets acquired to be immediately expensed subsequent to acquisition. FAS 141R requires in-process R&D costs to be measured at fair value, capitalized, and annually measured for impairment pursuant to FAS 144 (Wenk, 2008). While capitalizing in-process R&D rather than grouping its implied value in goodwill gives readers of the financial statements more transparency, it is inconsistent with the treatment of R&D traditionally expensed in on-going operations. Advocates of capitalization point out that contracted R&D is reported on the sponsor's financial statements as an asset. IFRS 3 does not address this area since R&D capitalization is permitted under global standards making the issue moot for the IASB.

CONCLUSIONS AND RECOMMENDATIONS FOR REVISIONS IN FAS 141R AND IFRS 3

The FASB released FAS 141R to replace the FAS 141 and put a greater focus on financial reporting as it moves toward fair valuation of all assets and liabilities. While the FASB believes it has succeeded in improving the relevance and representational faithfulness of financial reporting for business combinations with the issuance of FAS 141R, it is clear that constituents believe there is still more work to be done. Although complete agreement between constituents and the FASB is unlikely, efforts made to harmonize U.S. GAAP with international standards are encouraging.

FAS 141R replaced the purchase method with the acquisition method of accounting for business combinations based on a belief that assets and liability measurements using current information are generally preferable to valuations using less current information. Such fair value measurements render organizations vulnerable to less than reliable financial reporting and leave earnings management practices in their wake. Thus, it is recommended that the FASB adopt the IFRS 3 approach of measuring the non-controlling interest at its proportionate share of the identifiable net assets rather than at the full fair value. This approach will value the non-controlling interest based on an observable, market-based acquisition amount that is level-1 evidence according to FAS 157.

FAS 141R requires that contingencies and assets and liabilities arising from contingent considerations be recognized at fair value on the acquisition date but fails to delineate how such fair value determinations should be made. To the extent these valuations involve estimates associated with minimal (50%) likelihoods, comparability of financial results among firms may be impaired. Thus, it is recommended that FASB converge to the IASB requirement that contingencies are valued using standards of higher likelihood associated with FAS 5 requirements.

FAS 141R capitalizes purchased in-progress R&D at fair value as an intangible asset and recommends occasional testing for impairment. Investments in R&D after the acquisition date continue to fall under the guidance of FAS 2 and are expensed. The question that arises is why does acquired in-progress R&D have value, while future additions to the acquired in-progress R&D or internally developed in-progress R&D do not have value? FAS 141R contends that internal R&D costs are management representations and constitute level 3 evidence under FAS 157 while purchased R&D has higher level 1 evidence status. In contrast, IFRS 3 capitalizes R&D. FASB's conservative approach to valuing R&D, specifying R&D efforts be expensed except when they are purchased, increases the reliability of financial reporting. As such, the IASB should converge to FASB's method of accounting for R&D, expensing internal R&D costs and capitalizing only purchased R&D in accordance with FAS 141R.

FASB succeeded in moving toward fair-value accounting and global convergence with FAS 141R. The remaining convergence issues can be resolved by focusing on the recommendations above. In addition, push-down accounting procedures can be used within the context of the entity theory to record subsidiary assets, liabilities, equities, and income that will lead to true one line consolidation entries by the parent.

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