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PUBLIC SECTOR ACCOUNTING

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Chapter 11
Consolidated financial statements

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Summary

This chapter introduces consolidated financial reporting in general and highlights public sector specifics. The aim is to provide insights into the concept of 'group' or 'economic entity', the reasons for consolidation, the peculiarities of the public sector, and the underlying theories of consolidation. The different types of influences and consolidation methods are explained. The chapter outlines the differences between consolidated financial statements and whole of government accounts and shows organisational challenges for preparing consolidated financial statements. Finally, a short overview about consolidated financial reporting in selected European countries is presented.

Keywords

Consolidation, consolidated financial reporting, whole of government accounting

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1. Introduction: The group as an accounting phenomenon

The preceding chapters have focused on the financial statements (FS) of individual public sector entities (single entity FS). To perform their functions, however, public sector entities often rely on other entities in which they have equity interests, voting rights, or other sources of influence. This is particularly true for primary governments, i.e., public sector entities which have "a separately elected governing body – one that is elected by the citizens in a general, popular election".[1] A municipality, for example, may provide public services not only through its own departments, but also by means of separate, legally independent entities such as public utility companies, municipal housing companies or wastewater associations. These arrangements have become particularly common following New Public Management (NPM), which has encouraged the disaggregation of formerly monolithic public entities[2] and the establishment of legally separate authorities, agencies, and government-owned enterprises (state-owned businesses) as well as the development of public-private partnerships. Hence, **a need exists for an "appropriate accounting tool" that provides financial information on the "group of entities" as a whole**[3].

In general, a **'group'** or **'economic entity'** is composed of at least two legally independent entities: a focal entity representing the group's nucleus (commonly referred to as the 'parent' and generally represented, in the public sector, by a primary government) and at least one affiliated entity (called a 'subsidiary' or a 'special purpose entity' in the private sector). The criteria whereby an entity can be qualified as being affiliated to another entity have been extensively discussed

[1] GASB 14.13.

[2] Hood (1995)

[3] Santis, Grossi, and Bisogno (2019), p. 230.

both in the academic literature and by accounting standard setters. The most widespread approach makes reference to the **principle of control**, so that **a group is generally conceptualized as being composed of a controlling entity and at least one controlled entity.**

For any given economic entity, **consolidated financial statements (CFS)**, if prepared, will **present the assets, liabilities, net assets/equity, revenues, expenses, and cash flows of the controlling entity and its controlled entities as if they were a single entity.** This reference to a virtual single entity is often referred to as the 'single entity fiction'.[4] As a first approximation, consolidation is achieved by summing up like items of the controlling and the controlled entities line-by-line. For example, if the value of Property, Plant and Equipment (PPE) – or accounts payable, or fee revenues, or labour expenses – is 100 EUR for the controlling entity and 200 EUR for the controlled entities, the corresponding amount in the CFS will generally be 300 EUR. In fact, however, **CFS do not merely sum up the FS** of the single entities belonging to the same economic entity. Rather, they aggregate such FS using specific consolidation techniques which eliminate the effects of intra-group transactions (i.e., the transactions that occurred between entities belonging to the group and are thus inconsistent with the single entity fiction) and deal with the possible presence of non-controlling interests (i.e., the remaining interests that are held by third parties in controlled entities, as in the case of outside investors – investors not belonging to the group – holding minority shares in a government-owned corporation controlled by a primary government).

The first CFS were prepared by U.S. private sector entities around the turn of the 20th century.[5] Since then, for private companies, CFS

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[4] Aggestam-Pontoppidan and Andernack (2016), p. 308.

[5] J.P. Morgan is attributed to have insisted on consolidated accounts for his steel holding company in 1901, see Mueller; Gernon and Meek (1997), p. 103.

have become the norm, especially if the company's debt or equity instruments are traded in a public market. IFRS 10.2, in particular, "requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements". In the public sector, on the contrary, this is not always the case. Reforms, primarily in Anglo-Saxon countries, have indeed driven the adoption of 'consolidated accounts' or even 'whole of government accounts'.[6] However, as consolidated accounting creates several organizational challenges, some jurisdictions have not yet introduced the legal requirement for consolidated financial reporting in the public sector, while others introduced it only to later withdraw it. This latter case occurred, for example, in some federal states of Germany, where small local governments no longer need to prepare CFS.[7] This decision was attributed to the costs of preparing CFS being greater than the corresponding benefits. Still, both practice and research are predominantly of the view that CFS foster accountability and support decision-making – for example, because CFS reveal the 'true' extent of the primary entity's indebtedness when liabilities are spread over several public sector entities belonging to the same economic entity[8].

The aim of Chapter 11 is to introduce the fundamental concepts concerning CFS. To some extent, these concepts are comparable with those used in the private sector; however, the chapter is also intended to highlight specific issues related to the public sector. Chapter 12 is specifically devoted to consolidation under IPSASs. Thereby, both chapters take accrual-based financial statements as a starting point. Conversely, the consolidated presentation of budgets

[6] See Brusca and Montesinos (2009), p. 243.

[7] For instance, in the German federal state Mecklenburg-Vorpommern: Kommunales Haushaltsrecht - Regierungsportal M-V (regierung-mv.de)

[8] See e.g. Chapter 8 for the terms accountability and decision-making support.

lies outside the scope of these chapters, regardless of whether the budgets are cash or accrual-based.[9] Horizontal peer groups, where two or more entities have strong and continuous relationships, but lack a parent entity, are similarly scoped out of these chapters.

This Chapter 11 is structured as follows. Section 2 presents the objectives of consolidated financial reporting. Section 3 introduces the group as a fictional entity and discusses its perimeter, i.e., the 'area of consolidation'. Section 4 presents the methods for consolidated accounting and the theories of consolidation. Section 5 introduces the procedures for full consolidation, which are further addressed in Chapter 12 with IPSASs-based examples. Organizational challenges are discussed in Section 6. Finally, a conclusion is provided in Section 7 together with a comparative table showing the status quo of consolidated public sector financial reporting in selected European countries.

2. The objectives of consolidated financial reporting

Consolidated financial reporting is intended to "provide relevant and undistorted financial information to internal and external stakeholders that encompasses every subsidiary or department and clears out any internal transactions, as well as mutual assets and liabilities".[10] To offer such view, CFS have long been argued to be necessary also in the public sector context.[11] This necessity, in fact, has become even stronger following NPM-inspired public sector reforms. One element of NPM is that it fragments the public sector

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[9] See Bergmann et al. (2016), p. 772 for a short explanation of cash-based traditional approaches.

[10] Bergmann et al. (2016), p. 766.

[11] See e.g. Heald and Georgiou (2000) and Lande (1998).

into smaller organizations. Such disaggregation is claimed to improve both efficiency and accountability, but it may end up obscuring the broader picture. Hence the importance of consolidation both for overall system control and for public accountability.[12] In the absence of consolidation, in fact, primary governments may be encouraged to pursue an "escape out of the budget [...] for the purpose of hiding public debt"[13] by shifting expenses and liabilities to affiliated entities. However, Walker (2009) warns that, for some information needs (e.g., to inform about the efficiency of service delivery), other financial statements or budget reports may be more suitable.

Based on theoretical considerations, Walker (2009) puts forward a list of routinely made judgements, for which CFS prepared at the central government level may deliver useful information.[14] The list includes:

1. Results and sustainability of a government's financial management practices;
2. Capacity to continue to deliver existing levels of services (or to enhance those services);
3. Manner in which a government is pricing services;
4. Extent to which a government is funding or delivering subsidized services;
5. How government has spent taxpayers' funds and any borrowings;
6. Whether a government is incurring obligations which will impose burdens on future generations;
7. Attractiveness of investing in government securities;
8. Attractiveness of maintaining investment in government securities;

[12] Heald and Georgiou (2009).

[13] Bergmann et al. (2016), p. 764.

[14] See Walker (2009), p. 200, Table 3.

9. Financial circumstances of regional governments vis-à-vis other regional (state) governments; and
10. Financial circumstances of nations vis-à-vis other nations.

This list, however, refers to a specific category of CFS and does not apply to CFS at all government levels. Thereby, Walker (2009) stresses the need to first identify the **addressees and users of CFS**, to then figure out their information needs and thus adjust the objectives and features of CFS. He also suggests that several kinds of CFS may be necessary depending on information needs. Multi-column CFS might even be required, so as to consolidate different sets of entities (e.g., only general government entities or also financial and non-financial government-owned enterprises; only controlling and controlled entities or also other types of affiliated entities) or to consolidate a given set of entities using different methods (e.g., full, proportional or equity/one-line consolidation)[15].

The addressees and users of public sector CFS are strongly debated in practice and research.[16] Usually, the following users/stakeholders are discussed to benefit from CFS through greater transparency and better support for decision-making: **internal users** such as politicians, managers, and employees as well as **external stakeholders** including citizens in their capacities as voters, taxpayers, and users of public services, but also suppliers, other public administrations, and financial institutions.[17] For internal users, CFS can represent a tool for "steering and controlling the direct and indirect provision of public services" and for "public decision-making in programming and controlling the different public policies".[18] With respect to ex-

[15] See Sections 3 and 5 for a discussion of the scope and methods of consolidation.
[16] See e.g. Walker (2009) and Bergmann et al. (2016).
[17] Santis, Grossi and Bisogno (2018), p. 242.
[18] Bergmann et al. (2016), p. 766.

ternal stakeholders, for example, banks could use CFS in order to assess the creditworthiness of the economic (fictitious single) entity while, for rating agencies, CFS may be useful to assess solvency and financial risks.[19] However, empirical findings about the actual usefulness of CFS remain sparse, especially with respect to citizens.[20]

3. The group as a fictional entity and the area of consolidation

The concept of economic entity is based on the observation that a set of single entities, which are legally independent, may represent one entity from an economic point of view. Thereby, an 'economic entity' or 'group' is created where the single entities fictitiously lose their legal independence and are treated in accounting as dependent operations of the focal entity. Thus, the economic entity exists and is accounted for based on the single entity fiction. Accordingly, the group does not legally exist and may also not be subject to tax law in many jurisdictions.[21] In a public sector context, Clarke and Dean (1993) stress that groups of governments with their controlled entities are "a fictitious structure, without legal power to exercise rights or incur physical or financial damage."[22] For the public sector, the term 'economic entity' may be somehow misleading since government entities do not strive for profits and have other purposes than private sector entities. In this regard, the term '**service providing entity**' would be more suitable. However, for consistency within the commonly used accounting terminology, this textbook uses 'economic entity' in the following.

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[19] Bergmann et al. (2016), p. 766.

[20] Walker (2009); Bergmann et al. (2016).

[21] Küting and Weber (2018), p. 92.

[22] Clarke and Dean (1993) cited by Grossi et al. (2014).

When preparing CFS, a crucial decision is the identification of the entities that must be classified as being part of the group and whose accounts must consequently be consolidated. In other words, the **area of consolidation** or **scope of consolidation needs to be clarified**. For accounting standard setters, this translates into the need to define appropriate criteria concerning the scope of consolidation.

Chapters 11 and 12 of this textbook draw on the **concept of control as the leading principle to define the scope of consolidation**, because control is the principle predominantly used both in the private sector and in European public sector accounting (PSA), as also shown in Table 11.3 with specific reference to selected European countries.

Control is seen as the strongest form of influence of one entity over another. The definition of control is complex in general and even more so in the public sector.[23] A frequently used presumption is that an entity controls another if it holds more than 50 percent of voting rights in the other entity. Control can be exerted **directly** by the controlling entity and/or **indirectly** through one or more controlled entities. Indirect control occurs when the economic entity consists of a chain of controlling relationships whereby a controlled entity holds control of another entity, i.e., it is itself a controlling entity. Such indirect control is also called 'pyramiding control'. A mixed direct and indirect control occurs when a majority of voting rights in an entity is held in part directly by the controlling entity and in part by one or more of its other controlled entities. Importantly, under mixed control, the total voting rights held by the controlling entity correspond to the unweighted sum of the rights held directly and indirectly. This is because the controlling entity has control over all the rights held indirectly via controlled companies, regardless of the presence of non-controlling interests.

[23] See also Brusca and Montesinos (2009). Chapter 12 presents the definition provided by IPSASs.

For example, for assessing the control criterion, assume that Alpha owns 80% of Beta and 30% of Gamma, while Beta owns another 25% of Gamma. The total voting rights controlled by Alpha in Gamma are 30% + 25% = 55%, not 30% + 25% x 80% = 50%. This is because, by controlling Beta, Alpha controls the entirety of Beta's voting rights in Gamma. Due to the 55%, Gamma is included in the CFS as a controlled entity. Nevertheless, Alpha's share in Gamma's net assets is 50%, which is relevant when consolidating the entities' financial reports.

Figure 11.1 exemplifies the identification of the consolidation area when control is chosen as the leading principle.

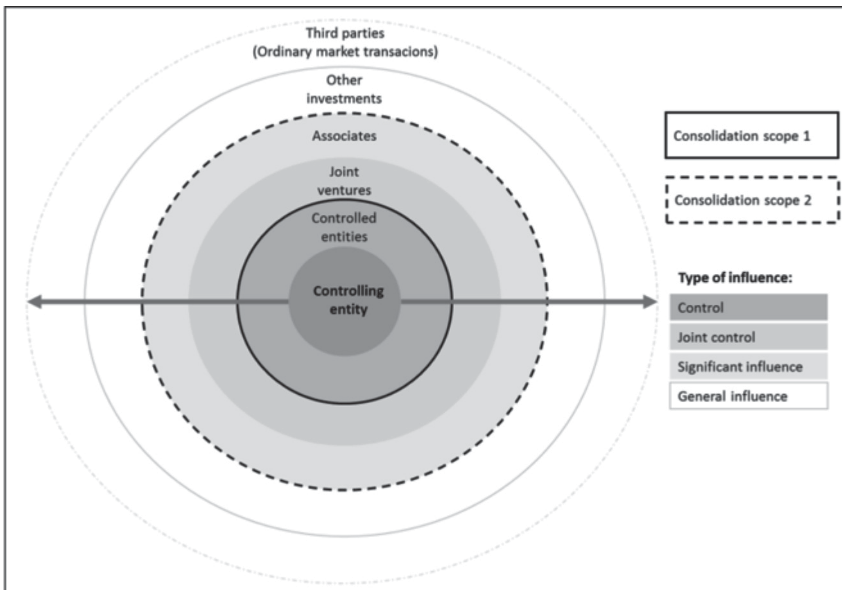

Figure 11.1: Scope of consolidation – between hierarchy and market

In a **narrow sense** (consolidation scope 1), the area of consolidation will encompass the parent entity as well as the entities that are controlled by the parent entity. Thus, it consists of controlled entities and the controlling/parent entity. In a **broader sense** (consolidation

scope 2), the area of consolidation will also encompass two further types of entities, that is, joint ventures and associates. In a **joint venture**, two or more independent parties (not relating to the same group) have **joint control** over an entity and share rights to the entity's net assets,[24] so that decisions about the entity's activities require the unanimous consent of the parties sharing control. An **associate** is an entity over which the parent has **significant influence**. Significant influence exists if the parent entity has neither control nor joint control over another entity, but it has the power to participate in the financial and operating policy decisions of such entity. In terms of voting power (if applicable), the investing entity is presumed to have significant influence if it holds at least 20% of the voting power in an investee, but not more than 50%, which would confer control. If influence is weaker, (almost) normal arm's length relationships are assumed, so that no consolidation is required or appropriate. The parent's and the controlled entities' (almost) normal investments in other entities are included in the CFS as financial assets, in the same way as an individual entity would present its equity investments in its own FS.

Using the concept of control to define the scope of consolidation, however, is not uncontested in public sector research and practice. Accounting standards that rely on the concept of control generally prescribe full consolidation[25] only for the entities that fall into the (narrow) consolidation scope 1. As a consequence, the assets, liabilities, revenues, expenses and cash flows of associates and joint ventures are not included in the CFS. Even more critically, as highlighted by e.g. Grossi and Steccolini (2015) and Bisogno et al. (2015), the public sector is characterized by "alternative control forms, funding and financial dependence relationships", and bailout expectations which

[24] For the distinction between joint operations and joint ventures as variants of joint arrangements, see Chapter 12.

[25] See Section 4 of this Chapter for an explanation of full consolidation and Chapter 12 for examples.

"are not only or mainly based on the concept of ownership" and are not properly captured by traditional control indicators.[26] Under these circumstances, using the concept of control to define the scope of consolidation may have a "negative effect in terms of financial disclosure". This is especially true in the presence of "fragmented ownership, contractual relationships, and use of significant municipal subsidies", as "some entities that are not controlled but significantly funded by the government budget, or are only able to survive on contract with the government, are not included in the area of consolidation", although the focal public sector entity is retaining financial responsibility.[27]

Other perspectives and approaches could therefore be more appropriate to define the scope of consolidation in the public sector. **Suggestions include the risk perspective, the organizational and legal perspective, the budget or budgetary perspective, and the statistical perspective**,[28] with the last two being particularly influential.

According to the **budget or budgetary perspective** CFS should include all the entities that receive significant financial support from the focal government's budget. This perspective is particularly consistent with a view of CFS as predominantly serving accountability purposes. In the U.S., for example, GASB 14.10 highlights that "the concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions". In particular, "the elected officials are accountable to those citizens for their public policy decisions, regardless of whether those decisions are carried out directly by the elected officials through the operations of the primary government or by their designees through the operations of specially created organizations"

[26] Grossi and Steccolini (2015), p. 332.

[27] Grossi and Steccolini (2015), pp. 330 and 332.

[28] See Bergmann et al. (2016), p. 769 for a detailed description of these perspectives.

(GASB 14.8). Therefore, "the financial reporting entity consists of (a) the primary government, (b) organizations *for which the primary government is financially accountable* [italics added] and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete" (GASB 14.12). Financial accountability generally entails the primary government's appointment of "a voting majority of an organization's governing body", but "a primary government may also be financially accountable for governmental organizations that are fiscally dependent on it". With respect to the European public sector context, a frequent suggestion is that **financial dependence should supplement** rather than replace **control**. Carini and Teodori (2021), for example, argue that control "will not grasp all the nuances of the public group" and that "the budget approach is more effective in providing a complete representation of the resources entrusted to and managed by [...] governments". However, they also acknowledge that "the control approach better approximates financial results"[29].

Under the **statistical perspective**, the scope of consolidation overlaps with the so-called general government sector (GGS)[30]. GGS is defined as including "all institutional units which are non-market producers controlled by government, whose output is intended for individual and collective consumption, and are financed by compulsory payments made by units belonging to other sectors; it also includes institutional units principally engaged in the redistribution of national income and wealth, which is an activity mainly carried out by government"[31]. GGS includes all levels of government, even

[29] Carini and Teodori (2021), p. 432.

[30] See Chapter 1 for a definition.

[31] Eurostat. Manual on Government Deficit and Debt. Implementation of ESA 2010. 2019 edition. Section 1.2.1, para. 1.

in a federal setting, where states are clearly not controlled by the national government. Conversely, it "excludes market public producers […], which are classified in the non-financial corporations […] or financial corporation […] sectors"[32]. Because of this focus on the GGS, CFS prepared according to the statistical perspective are close to Government Finance Statistics (GFS), whose main goal is to provide macroeconomic information concerning each of the different sectors of the economy[33]. Figure 11.2 shows the financial reporting entity[34] from a macroeconomic point of view, with its differentiation between the GGS on the hand, public non-financial and financial corporations (in bold rectangles) on the other.[35]

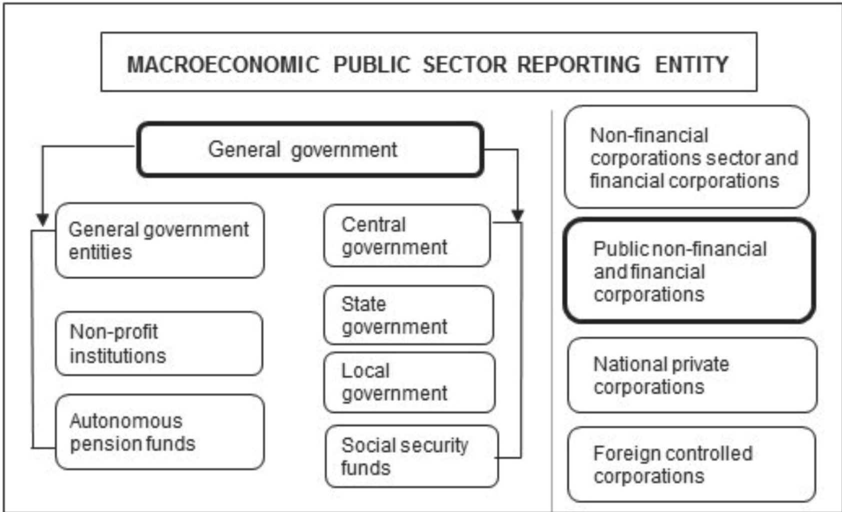

Figure 11.2: Macroeconomic public sector reporting entity
(Source: Brusca and Montesinos, 2009)

[32] Eurostat. Manual on Government Deficit and Debt. Implementation of ESA 2010. 2019 edition. Section 1.2.1, para. 2.

[33] Bisogno et al. (2015), p. 313.

[34] See glossary for a definition and for further references in the book.

[35] See Brusca and Montesinos (2009) for more detailed explanations.

Comparisons are often drawn between GFS on the one hand, and the concepts of **whole of government accounting (WGA)** or **whole of government financial reporting (WGFR)** on the other[36]. WGFR aims to present "the overall financial position of the government of a particular jurisdiction [...] via the consolidation of the financial statements and transactions of all the entities controlled by the jurisdiction's government"[37] and the resulting preparation of "statements encompassing the whole of a specific tier of government" (e.g., the central government, all state / regional governments or all local governments) or, in fact, the whole of all tiers of government, as in the UK.[38]

Similar to GFS, WGFR does not focus on individual economic entities (e.g., a municipal government and its controlled entities); rather, it takes a broader approach by including the whole of one or more tiers of government. GFS, however, measure financial position and performance according to their own statistical methodologies and conventions, while WGFR generally relies on IPSASs, IFRSs or the relevant national adaptations. GFS, moreover, pursue international harmonisation and comparability; WGFR, conversely, presents significant national specificities in the actual scope of consolidation[39]. This is also because, in some countries, the national government has control over its state and local governments, whereas in other countries it does not, due to different constitutional arrangements. As a result, whole-of-government reports are not standardized and internationally comparable. In other words, disparities exist as to what parts of the public sector (as depicted in Figure 11.3) are encompassed by WGFR in different countries.

[36] See Chapter 5 for more details.

[37] Santis, Grossi and Bisogno (2018), p. 231 with further references.

[38] Chow et al. (2019).

[39] Brusca and Montesinos (2009), p. 243.

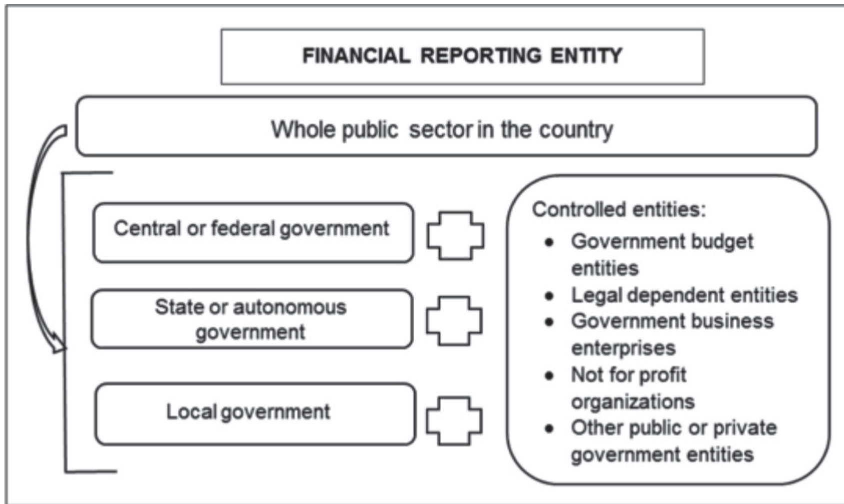

Figure 11.3: Financial reporting entity
(Source: Brusca & Montesinos, 2009)

As mentioned, the country with the most extensive whole-of-government scope of consolidation is the UK. In the UK, whole-of-government accounts are viewed as the "most consequent approach to CFS"[40]. They comprise all tiers of government as well as public corporations. Notable exclusions are "entities that are not responsible to an executive arm of government"[41], among which Parliament and the National Audit Office. Nationalized banks are also excluded.[42] Significantly, Heald and Georgiou (2009) highlight that "there is no mention of 'control' as a criterion for determining whether an organization is included in the UK's WGA"[43]. This is because the Government Resources and Accounts Act 2000 "requires HM Treasury to consolidate entities that appear to HM Treasury to 'exercise functions of a public nature' or

[40] Bergmann et al. (2016), p. 776.

[41] UK Whole of Government Accounts, 2019-20, Annex 2.

[42] Chow et al. (2015).

[43] Heald and Georgiou (2009), p. 224.

to be 'substantially funded from public money'". This is achieved by making reference to "the Office for National Statistics (ONS) classification of the public sector", so as "to ensure the accounts are consistent and comparable to other measures of financial performance, such as the National Accounts". An indirect reference to the control concept is included by highlighting that the ONS takes "account of the degree of control that government has over each entity"[44]. In other words, the UK's WGA has been combining the control and the statistical perspectives to meet the need for a "clear line of sight" from WGFR to CFS, lest "the practical impact of the former on policy formation and fiscal surveillance [...] be greatly reduced [...] given that macroeconomic policies and obligations generally depend on national accounts definitions"[45].

The process of WGFR is very data intensive and complex.[46] In addition, for federal countries, it is argued to be very challenging, but "less useful".[47] As a consequence, WGFR is not very widespread, but only applied by few countries.[48] In the UK, WGFR has traditionally been criticized by both politicians and academics due to ongoing qualified audit opinions (i.e., audit reports highlighting certain quality issues) and to delays in the preparation and publication of the statements.[49] Recently, however, its merits have begun to be recognised. The UK's Public Accounts Committee has described it as the most "complete and accurate of pictures to the UK's public sector finances"[50]. According to Stewart and Connolly, WGFR has highlighted assets and liabilities that are not captured by GFS, such as future pension liabilities, clin-

[44] UK Whole of Government Accounts, 2019-20, Note 1.3.

[45] Heald and Georgiou (2009), p. 220.

[46] Brusca and Montesinos (2009).

[47] Bergmann et al. (2016), p. 776.

[48] Brusca and Montesinos (2009), p. 243.

[49] Stewart and Connolly (2022).

[50] UK Public Accounts Committee. (2021), p. 4.

ical negligence claims, and public private partnership obligations; it has also seemingly started to support planning, facilitate decisions on the use of assets, increase transparency, and stimulate debates on long-term risk management and fiscal policy[51].

4. Consolidation methods and theories of consolidated accounts

Once the scope of consolidation has been defined, another crucial decision is the **choice of consolidation method(s)**, with specific reference to (1) full consolidation, (2) proportional consolidation and (3) the equity method.[52]

Under **(1) full consolidation** (also called "line-by-line consolidation"), the assets, liabilities, revenues, expenses and cash flows of the controlling entity and its controlled entities are fully included in the CFS on a line-by-line basis, irrespective of the controlling entity's share in the equity of the controlled entities. In the presence of non-controlling interests (NCI), such interests are presented in the consolidated balance sheet as a separate item within liabilities or equity. Accordingly, in the consolidated statement of financial performance, the share of surplus or deficit attributable to NCI must be separately disclosed. Transactions between the group's entities are eliminated in full. This includes the offsetting of mutual receivables and payables (in the balance sheet), revenues and expenses (in the statement of financial performance), and cash flows (in the cash flow statement). It also includes the elimination of both double counting and economic transactions not yet realized with third parties (in the three statements mentioned). The procedures associated with full consolidation are explained in detail in Section 5.

[51] Stewart and Connolly (2022).

[52] See e.g. Mori (2016) and Krimpmann (2015) for detailed explanations.

Under **(2) proportional consolidation**, the assets, liabilities, revenues, expenses and cash flows of the controlling entity are once again fully included in the CFS. Those of the controlled entities, however, are included only to the extent of the controlling entity's portion in the equity of such controlled entities. Transactions between the group's entities are eliminated only to that same extent. Correspondingly, NCI are excluded from the CFS.

Strictly speaking, the **(3) equity method** (also called "one-line consolidation") is not a method of consolidation. Under this method, the equity investments held by an entity continue to be disclosed as financial assets in that entity's balance sheet, but they are measured in a particular manner. Initially, they are recognised at fair value, which normally coincides with cost at the point of acquisition. Subsequently, their carrying amount is increased or decreased to recognise the investor's share of the investee's surplus or deficit after the date of acquisition, the distribution of dividends from the investee to the investor, as well as other changes in the investee's equity that are not recognised in the investee's surplus or deficit (e.g., changes arising from the revaluation of PPE) – converging towards the investment's fair value. For the purposes of consolidation, using the equity method for an affiliated entity implies that, in the consolidated balance sheet, the controlling entity's interest in such affiliated entity is reported as a financial asset and that the value of such asset will change over time to reflect changes in the affiliated entity's equity. The affiliated entity's assets, liabilities, revenues, expenses and cash flows, conversely, will not be included in the consolidated statements. Hence, the label 'one-line consolidation'.

The impact of the three methods is exemplified in Table 11.1. The example deliberately ignores which method would be required by existing accounting standards and is only intended to highlight the differential impact of the three methods. In particular, the example shows that, even in a very simple situation, the resulting representa-

tions of an economic entity's financial position and performance are significantly different across the three methods.

Example of consolidation methods

Alpha is a primary government which holds 70% of the shares in Company Beta. Table 11.1 shows simplified statements of financial performance and balance sheets for Alpha and Beta. It also shows the relevant CFS under full consolidation, proportional consolidation, and the equity method. The example relies on several simplifying assumptions, including that (i) Alpha acquired the shares in Beta at the beginning of the financial year for which the statements are shown; (ii) the consideration paid by Alpha to purchase 70% of Beta's shares (700 EUR) coincides with 70% of the value of Beta's reported equity (70% * 1000 EUR); (iii) Alpha measures its financial investments at cost; and (iv) no mutual transactions occurred between Alpha and Beta.

For most items (cash, other non-cash assets, liabilities, revenues and expenses), the consolidated amount equals: (1) the sum of Alpha's and Beta's amounts under full consolidation; (2) the sum of Alpha's amount and 70% of Beta's amount under proportional consolidation, (3) Alpha's amount under the equity method. Alpha's investment in Beta is not presented in the consolidated balance sheet under full or proportional consolidation; with the equity method, conversely, it continues to be disclosed and its amount is adjusted to reflect Alpha's share of Beta's net income, with the adjustment being recorded as a revenue labelled "share of surplus of affiliated entities". Contributed capital and accumulated surplus / deficit are the same across the three methods. The presence of NCI is reported in the balance sheet only under full consolidation. Correspondingly, the 30 EUR portion of surplus attributable to NCI is included in net income only under full consolidation.

	Financial Statements			Consolidated financial statements		
	Alpha	Beta		Full	Proportional	Equity
- - - - - - - - - - - - *STATEMENT OF FINANCIAL PERFORMANCE* - - - - - - - - - - - -						
Revenues	8,000	900		8,900	8,630	8,000
Share of surplus of affiliated entities						70
Expenses	7,500	800		8,300	8,060	7,500
NET INCOME (*)	**500**	**100**		**600**	**570**	**570**
(*) Of which attributable to parent				*570*		
(*) Of which attributable to NCI				*30*		
- - - - - - - - - - - - *BALANCE SHEET* - - - - - - - - - - - -						
Alpha's equity investment in Beta	700	-		-		770
Other non-cash assets	10,000	1,500		11,500	11,050	10,000
Cash	1,000	500		1,500	1,350	1,000
TOTAL ASSETS	**11,700**	**2,000**		**13,000**	**12,400**	**11,770**
Contributed capital	3,700	1,000		3,700	3,700	3,700
Accumulated surpluses / deficits	800	-		800	800	800
Net income attributable to parent	500	100		570	570	570
NCI at the beginning of the period				300		
Net income attributable to NCI				30		
Liabilities	6,700	900		7,600	7,330	6,700
TOTAL LIABILITIES AND EQUITY	**11,700**	**2,000**		**13,000**	**12,400**	**11,770**

Table 11.1. Impact of different consolidation methods

The selection of consolidation methods is guided by accounting standards which, in turn, are inspired by specific **accounting theories**.

Accounting theories have already been addressed in Chapter 4 by explaining that they represent "a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures"[53]. Accounting research has relied on several theories to discuss the users and usefulness of CFS, including legitimacy, institutional, agency, and stakeholder theory.[54]

With respect to the choice of consolidation methods, reference is commonly made to three specific theories: (i) proprietary theory, (ii) parent company theory and (iii) entity theory. These theories were developed in the private sector, but they have also been discussed with reference to the public sector context.[55]

[53] See Chapter 4, p. 124.

[54] Santis, Grossi and Bisogno (2018).

[55] See also Chapter 4.

Proprietary theory views the group through the eyes of its ultimate owners only, that is, the shareholders of the controlling entity. The group's assets and liabilities are considered to be those of the owners and the CFS is viewed as an extension of the controlling entity's FS. Since NCI are not ultimate owners of the group, their share of equity is disregarded.[56] In terms of consolidation methods, this theory results in proportional consolidation.[57]

Parent company theory moves from the premise that, even in the presence of NCI, the controlling entity has control over the subsidiaries' assets and liabilities in full, rather than on a proportionate basis. In terms of consolidation methods, this theory results in full consolidation in the variant of disclosing partial goodwill. Variations exist as to the status of NCI and consequently their classification.[58] In particular, the holders of NCI can be alternatively viewed as a secondary set of owners or a particular class of lenders, with NCI being correspondingly classified within equity, among liabilities, or even in a dedicated class.[59]

Entity theory, finally, takes the perspective of the economic entity as a whole, as separate from its owners. The economic entity is viewed as having two classes of proprietary interests (controlling and non-controlling) which, however, are treated consistently for consolidation purposes, with no special treatment accorded to either. This perspective serves for all considerations of classification, measurement, and netting of assets and liabilities of the controlling and the controlled entities. In terms of consolidation methods, this

[56] See Kell (1953).

[57] See specifically for PSA e.g. Bisogno et al. (2015), p. 312.

[58] Measurement alternatives arise when the fair values of the subsidiary's assets and liabilities differ from the carrying values and in the presence of goodwill. These issues are tackled in Chapter 12.

[59] See e.g. Huefner & Largay III (1990) and specifically for PSA e.g. Bisogno et al. (2015), p. 312.

theory also results in full consolidation, with NCI being presented as a component of equity and full goodwill being disclosed.[60]

Traditionally, accounting standard setters have mainly found inspiration in parent company theory[61]. **Entity theory, however, is becoming increasingly influential** for being "fundamental to modern accounting as well as more appropriate, especially in the public sector".[62] CFS prepared in accordance with proprietary theory, on the contrary, are generally regarded as inappropriate information and decision-making tools[63] as they do not provide a complete insight into the fictitious single entity's financial position, performance and cash flows.

Consequently, **national and international accounting standards that prescribe consolidation on the basis of the control principle generally require the full consolidation of controlled entities. Proportional consolidation is usually limited to joint ventures, while the equity method may apply to associates and joint ventures**[64]. For the public sector, however, some national standard setters have extended the equity method to the consolidation of controlled entities. In some cases (e.g., Austria and France), the equity method has been introduced as an intermediate step towards full consolidation, while in others (e.g., Sweden and Switzerland) it appears to be a longer-term choice. The equity method has also been recommended for the consolidation of immaterial entities as well as entities whose activities are dissimilar from the controlling entity's. In this last respect, the full consolidation of controlled entities performing dissimilar activities and often characterized by 'strong balance sheets', such as national banks, financial intermediaries, or insurance companies, would mean

[60] See Moonitz (1942). Specifically for PSA, see e.g. Bisogno et al. (2015), p. 312.

[61] See e.g. Bergmann et al. (2016), p. 767.

[62] See e.g. Bisogno et al. (2015), p. 312.

[63] See e.g. Bisogno et al. (2015).

[64] Bergmann et al. (2016), p. 771. See example provided in Chapter 12.

that all the assets of these entities are included in the consolidated balance sheet. This could produce a misleading representation of the resources controlled by the economic entity. For this reason, Canada consolidates these entities using the equity method, while Austria and France outright exclude them from the CFS.[65]

Depending on the theory, the **objectives of consolidated financial reporting** are also different. Under entity theory, CFS are intended to provide a true and fair view of the group's position, performance and cash flows. Under parent company or proprietary theory, conversely, the true and fair view is largely limited to the parent's perspective, that is, the parent's own share or controlled part of assets, liabilities and net assets.

Generally, CFS have a pure **information function**. In contrast, according to some national accounting standards, FS also have a profit/revenue distribution function. In the municipal context, in particular, the frequent outsourcing of service delivery to public corporations hampers the transparency of local governments' FS. This stems from the fact that those unconsolidated (single entity) reports only present a partial view of the municipality's economic and financial activities, as the financial conditions of controlled entities, joint ventures and associates are not adequately considered.[66]

5. Procedures for full consolidation

As mentioned in Section 3, national and international accounting standards generally require the **full consolidation of controlled entities**.

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[65] See e.g. Bergmann et al. (2016), p. 777 and 780; Bisogno at al. (2015), p. 321; Walker (2011) pp. 487 and 492-493.

[66] Tagesson (2009).

Usually, the economic entity will not have a common accounting system. Moreover, the entities to be consolidated may not be required or even allowed by local legislation to apply the same set of accounting standards in the preparation of their own single-entity FS. Therefore, at the end of each reporting period, the original FS (henceforth labelled '**FS I**') of the entities to be consolidated must preliminarily be[67]:

- harmonised to comply with the group's accounting policies, the reporting date of the group, and its currency, hence producing '**FS II**';
- prepared for consolidation, which may entail a remeasurement of the controlling entity's and/or the controlled entities' assets and liabilities. Different alternatives exist as to this remeasurement, including the acquisition method, the pooling of interest method, and the fresh start method. These three methods are depicted in Table 11.2. The most commonly used alternative is the acquisition method. The acquisition method requires the remeasurement of the controlled entities' assets and liabilities at their acquisition-date fair values, thus revealing hidden reserves (e.g., items of PPE for which the fair value exceeds the carrying value) and hidden burdens (e.g., underestimated provisions). In subsequent consolidation periods, it also requires the recognition of the relevant changes in value, as in the depreciation of hidden reserves. Importantly, the remeasurement may also add assets and liabilities that were not included in the original FS of the entities to be consolidated – typically, intangible assets and further provisions. The end result is labelled '**FS III**'.

[67] See Krimpmann (2015), pp. 116 ff.

Entity	**Controlling entity**	**Controlled entity**
Method	Valuation of assets/liabilities	
Pooling of interest method	Book value	Book value
Acquisition (or purchase) method	Book value	Fair value
Fresh start method	Fair value	Fair value

Table 11.2: Remeasurement alternatives for the purposes of consolidation

Subsequently, **consolidation procedures** (sometimes also called '**consolidation steps**' in the literature) are performed as specified in the remainder of this section. Importantly, at the end of each reporting period, the previous years' consolidation procedures must be repeated to establish the status quo at the beginning of the current reporting period, followed by the consolidation procedures for the current period. This is because, each year, the CFS will be based on the FS I for the current period, which do not incorporate the harmonisations and remeasurements performed in the previous periods to produce FS II, FS III and, on that basis, CFS.

Full consolidation, in particular, encompasses **four different consolidation procedures**, which are shortly explained in this section by also highlighting public sector specificities:[68]

1) Net assets/equity consolidation;
2) Debt consolidation;
3) Consolidation of revenues and expenses; and
4) Elimination of unrealized gains or losses.

(1) Net assets/equity consolidation is also known as 'capital consolidation'. Its purpose is to prevent the equity of the controlled

[68] IPSASs-based examples are presented in Chapter 12.

entities from being double-counted on the consolidated balance sheet: on the one hand, as the difference between the controlled entity's assets and liabilities; on the other hand, as the controlling entity's equity investment in the controlled entity, which already incorporates the value of the controlled entity's assets and liabilities. To this end, the (a) carrying amount of the controlling entity's investment in each controlled entity, as reported in the controlling entity's balance sheet, must be offset against (b) the controlling entity's portion of each controlled entity's equity. In this process, it is important to highlight that consolidation procedures operate on FS III. Under the acquisition method, as mentioned, this entails the remeasurement of the controlled entities' assets and liabilities at their acquisition-date fair values, which will also produce a remeasurement of the controlled entities' equity. Any difference between (a) and (b) is recognised as goodwill (if positive) or badwill/bargain purchase (if negative). Goodwill is an asset, while the nature and treatment of badwill/bargain purchase varies across sets of accounting standards.

In the course of **(2) debt consolidation**, intra-group receivables and payables must be eliminated. These include accounts receivable and payable stemming from the exchange of goods and services within the group as well as loans and interest receivable and payable stemming from intra-group financing relationships. Accruals and deferrals relating to intra-group transactions may also be involved. The aim is to avoid double counting and to eliminate the effects of intra-group transactions on the presentation of the economic entity's financial position, as such transactions would not exist if the single-entity idea was not a fiction.

In the simplest case, mutual receivables and payables have identical amounts and can be neutralized by simply 'omitting' them. When differences exist, they must be recognised in surplus or deficit in the period in which they occur (and rebooked in subsequent con-

solidation periods in net assets/equity). In this respect, a distinction can be drawn between 'real' and 'unreal' offsetting differences:[69]

- **Real offsetting differences** arise when the group's entities apply different recognition and measurement rules. Most of these differences are identified and reconciled at the beginning of the consolidation process, when the original FS of the groups' entities (FS I) must be adjusted to the group's accounting policies, as required by the principles of uniformity (FS II).
- **Unreal offsetting differences** are caused by accounting deficiencies such as wrong journal entries, incorrect uses of intra-group accounts, and timing differences whereby the two entities recognise the effects of a mutual transaction in different accounting periods (possibly due to different lengths of booking stop periods before the same balance sheet date).

Under the **(3) consolidation of revenues and expenses**, intra-group revenues and expenses must be eliminated. This procedure is similar to debt consolidation, but it relates to the statement of financial performance as opposed to the balance sheet/statement of financial position.

During this procedure, a particular offsetting difference in the public sector can result from **consumption taxes** such as a sales tax or VAT. The correct consolidation of intra-group transactions in which the seller must charge a consumption tax, but the buyer is not eligible for consumption tax deduction, is largely unclear. Various solutions are discussed and applied in practice. For example, the offsetting difference may remain in the expenses after consolidation, or it may be eliminated.[70]

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[69] See Krimpmann (2015), pp. 278 ff.

[70] See e.g. Lorson et al. (2016), Note 715.

More generally, a public sector specific case of revenues and expenses consolidation is **tax consolidation**, which occurs whenever one of the consolidated entities pays taxes to another consolidated entity (e.g., a local authority).[71] To prepare CFS, the tax revenues (or expenses from tax refunds) of the local authority must be offset against the corresponding tax expenses (or income from tax refunds) of the other consolidated entity. Special features for tax consolidation arise, e.g., from combined federal, state and local taxes, whereby a public sector entity is entitled to collect a tax, but the relevant proceeds are shared among public sector entities at different government levels on a pro-rata basis. Combined federal, state and local taxes can be shown as liabilities from tax distribution. A further challenge in tax consolidation may arise from differences in the timing of recognition across the consolidated entities. These differences can result, for example, from the principle of asymmetric prudence: while the paying entity must recognise a corporate income tax expense as a provision (reduced by advanced tax payments) in the financial year when the taxed income (related to a taxable event) was earned, the receiving government may only recognise the relevant revenue once it has been sufficiently specified (e.g., with the publication of the tax assessment notice). In the course of consolidation, these offsetting differences of the current period will need to be reconciled, with an effect on surplus or deficit in the CFS (and, in subsequent consolidation periods, they will need to be rebooked in net assets/equity).

Another specific public sector application of revenues and expenses consolidation refers to **investment grants**, depending on how these grants are recorded by their recipient and by their provider. The provider will recognise a payable and, usually, an expense. The recipient will recognise a receivable; as for the account to be

[71] See e.g. Lorson et al. (2016), Notes 720 ff.

credited, depending on the underlying accounting norms, investment grants may alternatively be deducted from the acquisition or production cost of the subsidized items (net method) or recognised on the liabilities side as special items for investment grants or as deferred government grants (gross method). During consolidation, the provider's payable must be offset against the recipient's receivable. In addition, the provider's expense must also be eliminated. Correspondingly, when using the net method, the recipient's asset is to be remeasured to show its value without the grant's deduction; when using the gross method, the recipient's special item for investment grants or deferred government grants is to be eliminated. If any expenses or revenues arose from the investment grant in the reporting period, these also have to be reversed, with an effect on surplus or deficit.

As for grants in the form of **income subsidies**, the offsetting follows the general procedure for the consolidation of revenue and expenses.

Finally, the **4) elimination of unrealized gains or losses** deals with situations where a consolidated entity, after purchasing goods and services from another consolidated entity, capitalizes them as inventories, fixed assets, or intangible assets. In the preparation of its FS, the purchasing consolidated entity will measure these assets at its own acquisition costs. These costs will correspond to the selling consolidated entity's revenues, but not necessarily to the selling consolidated entity's acquisition or production costs. From the group's perspective, the selling consolidated entity's FS will incorporate a gain (or a loss) from the sale, but such gain or loss is unrealized because it was not generated in a sale to a third party. Correspondingly, the purchasing entity's FS will overstate (or understate) the value of the relevant assets because such assets were measured using the purchasing entity's acquisition cost (i.e., their book values include the gain/loss of

the selling entity) as opposed to the selling entity's (and thus the group's) acquisition or production costs. During consolidation, the unrealized gain or loss must be eliminated, and the corresponding overstatement or understatement must be removed from the assets' book values.

6. Organizational challenges

The preparation and presentation of CFS pose several organizational challenges. The range and severity of these challenges will also depend on the local legal requirements with which a public sector entity must comply. This section presents a (non-exhaustive) list of challenges, with a particular focus on the public sector context:[72]

1) Implementation of consolidated financial reporting;
2) Initial consolidation;
3) Requirements of uniformity;
4) Timely organization of the consolidation process;
5) Coordination of audits.

The **(1) implementation of consolidated financial reporting** needs adequate planning. Consolidated financial reporting (CFR) can be viewed as the supreme discipline of accounting and financial reporting as it covers all kinds of economic transactions at several layers of an economic entity. Therefore, the tasks to be carried out by the controlling entity and by the other entities to be consolidated must be specified in advance, together with the relevant methodologies and responsibilities. Skilled personnel is needed,

[72] See also Krimpmann (2015) or Lorson, Poller and Haustein (2019) for more detailed explanations.

with experience in the application of consolidation methods and the ability to oversee the relevant consolidation areas in the economic entity. This creates a high demand for qualified personnel, especially for the public sector. It also implies increased labour, training and consulting expenses. The volume of data for consolidated accounting and the complexity of the relevant treatments also require significant investments on enhanced information technology systems and accounting software.[73]

With respect to **(2) initial consolidation**, a public sector peculiarity is that consolidation requirements are recent and so are, in fact, the requirements regarding the preparation of accrual-based financial reports. As a consequence, controlling entities will begin to produce CFS long after having obtained control of their affiliated entities. Moreover, they will generally have incomplete records of the relevant transactions; hence the frequent need for strong assumptions and simplifications, as the strict application of consolidation rules would require the remeasurement of the controlled entities' assets and liabilities at their fair value as of the acquisition date.

As mentioned in the previous section, the preparation of CFS involves specific **(3) requirements of uniformity** in that the financial statements of the individual entities to be consolidated must be adjusted to comply with the group's accounting policies, reporting date, and currency. In the public sector, the harmonisation of accounting policies can be particularly cumbersome. Not only can rules, standards and practices vary across entities.[74] Public sector groups exist where some entities still use only cash accounting, while others

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[73] Bergmann et al. (2016), p. 766.

[74] See e.g. Walker (2011) for an in-depth analysis of the different (non-) recognition and valuation rules and practices across the jurisdictions that are consolidated in the Australian government's financial report.

use accrual accounting.[75] Alternatively, a primary government using accrual accounting may be required to apply PSA standards while its controlled entities, being established as joint stock corporations, must comply with private sector accounting standards.

To enforce uniformity, streamline the consolidation process, and improve the resulting quality of CFS, the controlling entity can issue a **consolidated accounts manual**. The manual should consider the group's overall features as well as its accounting structures and environment. On this basis, it should provide guidelines regarding the group's reporting date as well as its recognition, measurement, and disclosure policies. It may also prescribe a common chart of accounts. In the presence of foreign controlled entities, it will establish guidelines on language (of the report and of all communications concerning the report's preparation and presentation) and on currency conversion. Due to the importance and complexity of these issues, the manual should be documented in writing (at least in the group's main language) and agreed upon with the auditors.

A further challenge lies in the **(4) timely organization of the consolidation process** to comply with preparation, auditing and disclosure obligations and deadlines. To this end, a binding timetable should be drawn up and enforced for all controlled entities, joint ventures and associates.

Finally, with respect to the **(5) coordination of audits**, the audits of the FS of all controlled entities, joint ventures and associates must be coordinated with the audits of the controlling entity's FS and of the CFS, while ensuring compliance with national and local audit laws and regulations.

To conclude, it is important to notice that these challenges include one-off issues such as the initial consolidation and the initial

[75] Brusca and Montesinos (2009).

	Country					
	Austria	**Finland**	**Germany**	**Italy**	**Portugal**	**UK**
State of consolidated financial reporting	• Mandatory CFS at central level only • Ongoing transition to accrual accounting for all government levels. After completion: Mandatory CFS for central, state, and local governments[76]	• Central level: Consolidated central government financial statement (CCGFS) (less than 90 accounting entities) • Mandatory CFS for municipalities using the acquisition method or pooling of interest method[77]	Heterogeneous at central, state and local level (if accrual only): • Voluntary CFS at central and state level (currently prepared by only 3 federal states); • Mandatory CFS for municipalities[78] located in 12 of 16 federal states	• Mandatory CFS at regional and local level only • Ongoing transition to accrual accounting for all government levels. After completion: Mandatory CFS for central, regional, and local governments	• Mandatory CFS at central and local level	• Mandatory CFS at central and local level
WGA/WGFR	No	No	No	No	No (future plans)	Yes
Principle for scope of consolidation	Control	Control	Control	Control and financial dependence	Control	Control

[76] https://www.ris.bka.gv.at/GeltendeFassung.wxe?Abfrage=Bundesnormen&Gesetzesnummer=20009319 §23

[77] Referred to as "parity method": no goodwill or gains are recorded in the consolidation (See Oulasvirta in Brusca et al (2015), p. 73).

[78] With recently implemented exceptions for small local governments in some federal states.

Notable exceptions	Only consolidation of directly controlled entities	CCGFS do not contain government funds, government utilities, state owned companies or universities	Controlled entities with dissimilar activities to those of the controlling entity in most jurisdictions are not consolidated	The conditions for the identification of controlled entities include references to financial dependence. Affiliated, non-controlled entities are included (with exceptions) in the CFS using proportional consolidation		WGA does not include: Parliament, National Audit Office, Nationalised Banks WGA combines control and statistical perspectives to define scope of consolidation

Table 11.3: Status quo of consolidated accounting in selected European countries (Adapted from: Brusca et al. (2015))

preparation of the consolidated accounts manual, but also recurring issues such as the maintenance of the manual. If accounting policies change or new accounting standards become effective, moreover, the manual must be updated and the transition procedures explained. These updates may also introduce modifications to CFR-related processes in terms of timing, performance, responsibilities, and auditing.

7. Conclusion

This chapter provides an introduction to terminology and processes related to the preparation of CFS. Due to the increased fragmentation of the public sector and the network of relationships connecting each public sector entity with other entities, CFS can enhance transparency and support decision-making in the public sector much better than FS can do.

Despite its complex technical nature, consolidated financial reporting can be seen as an important development in PSA and reporting. However, on an international scale, many different approaches exist to the definition of the consolidation scope, the definition of the reporting entity and the choice of consolidation methods.

As a summary of this chapter, Table 11.3 provides an overview about consolidated financial reporting in selected European countries. Similar to the status quo of financial reporting by individual entities as shown in Chapter 1, the current situation is quite heterogeneous. However, commonalities lie in the definition of the consolidation area according to the control concept. As stressed in this chapter, the UK can be seen to pursue the most consequent approach to CFS, that is, WGA/WGFR. Chapter 12 continues to explain consolidation methods by specifically drawing on IPSASs and providing some numerical examples.

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Discussion topics

– Reasons for consolidated financial reporting in the public sector

– Information needs fulfilled by public sector CFS

– Consolidation methods: Which suits best the public sector?

– Single entity fiction versus the group as an economic (and service delivery) entity

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