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CHRISTOPHER NOBES

An Analysis of the International Development of the Equity Method

The equity method was used as an early form of consolidation for all subsidiaries in the U.K. and for certain subsidiaries in the U.S. Another use of the method in some countries, even in the era of full consolidation, has been in the financial statements of investor legal entities. This seems to result from using the equity method as a technique for valuation or as an aid in the preparation of consolidated statements rather than as a form of consolidation. The method has also been used as a substitute for consolidation for excluded subsidiaries or for controlled companies not included in the definition of subsidiaries. Later, the equity method was introduced for joint ventures and then for other forms of 'strategic alliance', but the latter bring definitional problems, which have led to a consensus around an arbitrary threshold of 20 per cent of voting rights. This article traces these developments across time and space, and criticizes several of the past and present applications of the equity method. There is also an examination of the development of the terms 'equity method' and 'associated company'.

Key words: Accounting; Equity; International.

Across time and across countries, the equity method has been used for different types of investees, and it has also been used in both unconsolidated and consolidated statements. The present international consensus about its use in consolidated statements for certain non-subsidiary investees is hard to defend on the basis of extant accounting conceptual frameworks or of legal concepts. The consensus about the threshold (20 per cent shareholding) connected to the use of the equity method seems to have arisen by accident. The spread of the equity method is another example of the international transfer of accounting technology, as

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CHRISTOPHER NOBES is PricewaterhouseCoopers Professor of Accounting at the University of Reading. The author is grateful for comments on an earlier draft and for other assistance from David Cairns, Janie Crichton (Accounting Standards Board, London), Sigvard Heurlin (Öhrlings Coopers & Lybrand, Stockholm), Jan Klaassen (KPMG and Free University, Amsterdam), Liesel Knorr (Deutsches Rechnungslegungs Standards Committee), Pat McConnell (Bear Stearns and Co., New York), Malcolm Miller (University of New South Wales), Michael Mumford (University of Lancaster), Christopher Napier (University of Southampton), Dieter Ordelheide (formerly of Goethe University, Frankfurt), Paul Pacter (IASC), Bob Parker (University of Exeter), Alan Roberts (University of Reading), Rolf Rundfelt (KPMG, Stockholm), Michael Wallace (Listing Department, London Stock Exchange), Stefano Zambon (University of Ferrara), Peter van der Zanden (Moret Ernst & Young, Eindhoven), Steve Zeff (Rice University), and to the editor and a referee of this journal. The author is particularly indebted to Malcolm Miller for information on Australia and on empirical studies, to Alan Roberts for information on European regulations, and to Steve Zeff for suggesting a study of early textbooks and for providing photocopies of some relevant parts of them.

outlined by Parker (1989) for double-entry bookkeeping and for the true and fair view requirement (see also Nobes, 1993, for the spread of the latter in Europe).

There are several forms of the equity method (e.g., see Ma *et al*., 1991, p. 188), but the common feature is the inclusion in the investor's income statement of the appropriate proportion of the investee's earnings rather than merely the dividends flowing to the investor or, at the other extreme, rather than the investee's detailed revenues and expenses. In the investor's balance sheet, there is also 'one-line consolidation' of the net assets of the investee rather than merely the cost of the investment and rather than line-by-line consolidation of assets and liabilities. As will be clear to users of American English, the term 'equity method' implies a measurement at the investor's proportion of equity (subject in some versions to adjustment for goodwill), which is equal to net assets. This article does not deal with the technical details of the equity method except when there are underlying theoretical issues of relevance to the paper's theme.

To begin, there is a description of the use of the equity method early in the twentieth century as a form of consolidation used before full consolidation had developed (called 'proto-consolidation', below). Its use in parent company statements (pseudo-consolidation) is also a long established treatment of subsidiaries. Another early use was in consolidated statements for excluded subsidiaries (substitute-consolidation). The next three sections below deal with these uses relating to subsidiaries.

In the 1960s, the equity method began to be recommended also for investments in certain non-subsidiaries: as a form of pseudo-consolidation in investor statements and as a form of semi-consolidation in consolidated statements. It is possible to see pseudo-consolidation and semi-consolidation as techniques of valuation rather than of consolidation. For all these uses, there has been opposition, concentrated in a few countries.

This article pieces together the above history, analyses the reasons for the rise of the equity method and assesses the strength of the criticisms. The threshold for the use of the equity method is also examined. One conclusion is that the forces of accounting harmonization might have overcome logic and law, and that the equity method is inappropriate for most, if not all, of its present uses; a point noted earlier by, for example, Chambers (1974) and Miller and Leo (1997). There is also a summary of previous academic research and a look at the development of the terms used in the context of the equity method in various countries.

Thus, the aim is to contribute to the literature on the international transfer of accounting technology, but there are also major policy implications for standard setting in an area of financial reporting where further developments can be expected soon (Milburn and Chant, 1999). The concentration is on major countries in the English-speaking world and Continental Europe. In the topic areas considered here, the rest of the world has probably derived its practices from these countries. For example, for Japan, there are many consolidation practices similar to those of the U.S.A., including the 20 per cent threshold for equity accounting (Sawa, 1998). Issues of special relevance to group structures in the Far East (e.g., the Keiretsu in Japan or the Chaebol in Korea) are not examined here.

PROTO-CONSOLIDATION

In the U.K., the earliest use of the equity method appears to be for the purposes of including subsidiaries in the financial statements of investors as an alternative to consolidation. This method was more common than full consolidation in the 1910s and was still used in the 1920s (Edwards and Webb, 1984, Table 1); for example by Lever Brothers (Edwards, 1989, p. 229). On the whole, the equity method was superseded, in the 1930s, by full consolidation or no consolidation; predominantly the latter (Bircher, 1988, p. 7). Another approach was to treat subsidiaries as though they were branches of the parent. This was still practised in the 1930s in such companies as Unilever (Hodgkins, 1979, p. 45). Only with the Companies Act 1947 did 'branching' finally disappear.

Walker (1978a, pp. 99, 117) suggests that the equity method became less popular because, in the context of the conservative mood following the Royal Mail case, it was interpreted as recognizing unrealized profit. However, Edwards and Webb (1984, p. 40) point out that the equity method is more conservative in the sense that it does not ignore losses of subsidiaries as the cost-based method can. As another part of the explanation, they note that the Greene Committee on law reform and the Companies Act 1928 provided no support for the equity method. The Act required holding companies to show shares in subsidiaries, which would not be shown naturally by the equity method. Counsel's opinion[1] suggested that the balance sheet of the legal entity should be the one filed and presented to the shareholders.

In the U.S., a more full-blooded approach to consolidation was taken at the beginning of the century, without much need for partial steps such as the equity method. This seems to be due to fewer legal problems in the U.S., less conservatism of practice, and to acceptance of consolidation for certain purposes by the tax authorities and the New York Stock Exchange (Edwards and Webb, 1984, pp. 41–7; Walker, 1978a, Section III). Nevertheless, the equity method was used in parent company statements for certain subsidiaries. For example, Kester (1918, p. 261) distinguished between parents which had 'substantially full ownership' of subsidiary companies and cases where 'ownership is not complete but still controlling'. For the latter, the equity method in parent statements was seen as a reasonable alternative to the preparation of consolidated statements.

PSEUDO-CONSOLIDATION

The early use of the equity method for subsidiaries in the financial statements of holding companies before the full development of consolidation is considered above under 'proto-consolidation'. However, its use has continued in parent statements in some jurisdictions despite inclusion of the subsidiaries in consolidated statements. In the U.S., a long line of textbooks describe and recommend the use of the

[1] Edwards and Webb (1984) refer to *The Accountant*, 31 August 1929, p. 281.

equity method in this context. Until the 1960s, there was little promulgated GAAP[2] in this area, so textbooks and monographs contributed to unpromulgated GAAP.

As noted above, Kester (1918) recommended use of the equity method in parent statements early on for certain purposes, but was still recommending it in his 1933 edition and the 1945 reprint of that (pp. 194–5), when consolidated statements had become fully developed. Perhaps because of the comparative lack of legal restraints, Kester (1918, p. 262) had no qualms about the resulting profit, suggesting that 'the profit taken onto the books of the holding company by the above method is a real, not a book, profit', given that the parent controls the subsidiary's dividend policy. A similar view was taken by Finney (1922, p. 42) for the investment account in the holding company's books, even though there would also be a consolidated balance sheet.

Moonitz (1944, p. 49) also advocated the use of the equity method in the parent's books for several reasons:

1. The cost method makes sense when there is uncertainty but that does not apply to subsidiaries (p. 48) over which there is full control of dividend policy (p. 49).
2. The status of the investments varies with the fortunes of the investees not with the movements of cash (p. 49). Income accrues as the investments increase in value. Income accrues to the parent when it accrues to the subsidiary (p. 52).
3. The validity of the subsidiary's profit calculation is as well established as the parent's (p. 49).
4. Because companies plough back part of their profits, the cost rule will probably understate parent income in prosperous periods (p. 53).

Incidentally, Carman (1932, p. 103) and Dickerson and Weldon Jones (1933, p. 200) also propose the method for the treatment of subsidiaries in the investment account of the parent. However, they see it as a useful arithmetic device for preparing consolidated balance sheets when there are several layers of subsidiaries. They seem to regard the resulting balance sheet of the parent as not important in its own right, so that they should not be seen as proposers of pseudo-consolidation.

The contrary point of view to that of Kester and Moonitz is argued by Kohler (1938) who suggests that 'no practical benefits are derived from accruing profit and loss of subsidiaries on the books of the controlling company'. This is strongly supported by Paton (1951), who specifically opposes Moonitz' arguments: 'He is recommending, in effect, that the parent company keep its own accounts from the consolidated point of view, and were his recommendation adopted there would be little excuse left for preparing consolidated statements' (p. 46).

Despite this disagreement, it is clear that the method was acceptable where it really mattered. Kester (1945, pp. 211–12) wrote that: 'The Securities and Exchange Commission considers the equity of a holding company in subsidiary profits and losses sufficiently important to require disclosure . . . if such equities are not taken up on the books of the holding company'.

[2] That is, 'generally accepted accounting principles' as adopted by a body approved by the SEC (e.g., currently, the Financial Accounting Standards Board).

Finney (1946) illustrates the use of the equity method and calls it the 'economic basis' of parent company accounting, but notes that it does not conform 'strictly to the legal realities' (p. 299). As a compromise, Finney recommends the equity method with the undistributable earnings shown separately in shareholders' equity (p. 301). The matter of whether equity-accounted profit was distributable seems not to have constrained the debate.[3]

When GAAP was promulgated in 1971 by APB Opinion 18 (para. 14), the equity method was required in parent statements. Although the requirement was subsequently removed by SFAS 94 (of 1987, para. 15), there is no replacement instruction, so the equity method can still be used in parent statements. The lack of U.S. interest in this area is because parent statements are not generally required to be filed. This is unlike the position in most countries, where the law deals with parent statements, sometimes clearly as less important than consolidated statements (as in the U.K.) and sometimes as more important (as traditionally in some other European countries).

There was no equivalent U.K. discussion, let alone advocacy, of the equity method for use in parent statements in the days before accounting standards, presumably for the legal reasons noted earlier. For example, Cropper's *Accounting* (Cropper *et al.*, 1932, p. 316) recommends that subsidiaries should be accounted for either at cost with attached statements or by consolidation. Similar recommendations come from Garnsey (1923 and 1931, ch. VI); and others are silent on the issue (e.g., Pixley, 1910; Dicksee, 1927; Dicksee and Montmorency, 1932; Bogie, 1949, 1959; Castle and Grant, 1970). Subsequently, the method was prohibited in the U.K. by accounting standard.[4] It is also not allowed for this purpose in Australia[5] (AASB 1016).

However, in the Netherlands, subsidiaries (and joint ventures and associates; see later) are reported by using the equity method in the unconsolidated financial statements of the investor (Art. 389 (1–3) Book 2, Title 9 of the Civil Code; Dijksma and Hoogendoorn, 1993, p. 132). This use of the equity method in parent statements is long-standing practice. For example, it can be found in the parent statements which accompanied one of the earliest examples of Dutch consolidation: that by Philips[6] in 1931. The treatment generally enables the equity of the parent to be equal to that of the group. The equity-accounted share of profit (in excess of dividends) is, under certain conditions,[7] shown as undistributable reserves (Art. 389 (4)). In order to allow such practices, an option was written into

[3] The notion of distributable profit was discussed early on (e.g., Hatfield, 1918, pp. 205–31) but the rules vary from state to state (e.g., Littleton, 1934, pp. 140–8).

[4] SSAP 1, para. 18; FRS 9, para. 26.

[5] Except where there are no consolidated statements.

[6] I am grateful, for this information, to Professor H. L. Brink, a former Philips executive. He writes, on 20 March 1999 to Peter van der Zanden, that 'The equity per the company only and the consolidated balance sheets was exactly the same' (translation by Peter van der Zanden).

[7] The elements for which the parent cannot control the distribution of profits.

the EC Fourth Directive (Article 59, as amended by Article 45 of the Seventh Directive). Consequently, the Netherlands and some other member states have enacted legal permission for this practice. For example, it is allowed and common in Denmark (Christiansen and Elling, 1993, p. 136), where the practice began in the 1970s (before the Directive). It is also allowed in France (Art. L340–4, Law of 3.1.1985) and in Italy (Civil Code, Art. 2426(4)), but is seldom used. Such permission is not granted in law in the U.K. or in Germany, where equity accounting is restricted to consolidated statements. Given this international difference, it is not surprising that IAS 3 deliberately excluded this issue (para. 3), and that its replacement (IAS 27) allows, but does not require, equity accounting for subsidiaries in an investor's financial statements (para. 29).

This use of the equity method in investor financial statements could be seen as an example of attempts by accountants to express commercial substance over legal form. Since an investor could usually obtain its share of profits in a subsidiary merely by requesting them, to recognize only dividends might seem like a legal nicety. A clue to another rationale for the use of equity accounting in investor statements can be found in the Dutch term for the method: *intrinsieke waarde* (intrinsic value). That is, this may be seen as a method of valuation rather than as a method of consolidation. Further, the consolidated statements are treated in Dutch law (Art. 406) as a note to the legal entity's statements, which raises an expectation of consistency of valuation, which is also encouraged by the Seventh Directive (Art. 292 (a)). These rationales are examined later.

SUBSTITUTE-CONSOLIDATION

Another use of the equity method, this time in consolidated statements, was as a back-up in cases where certain subsidiaries were not consolidated. For example, in the U.S., Accounting Principles Board Opinion No. 18 (of 1971) required the equity method for unconsolidated subsidiaries. The reasons for lack of consolidation in the rules of the 1950s onwards (Accounting Research Bulletin No. 51, para. 2; Accounting Research Bulletin No. 43, ch. 12, para. 8) include temporary control, control being with non-majority owners, large minority interest and foreign subsidiaries (particularly those subject to restrictions on the transfer of funds).

However, the AICPA proposed that, in those cases where there was lack of control or there were foreign exchange restrictions, the cost method would be more suitable (AISG, 1973, para. 50). More recently, SFAS 94 (of 1987) requires all subsidiaries to be included except when control is temporary or when significant doubt exists about ability to control. SFAS 94 removes the APB 18 requirement to use equity accounting for unconsolidated subsidiaries, although such treatment seems still to be allowed (Williams, 1996, p. 6.05).

One important piece of context is that the U.S. definition of a subsidiary seems to be based in practice on ownership of a majority of voting shares rather than on *de facto* control. Although ARB 51 refers to 'controlling financial interest', the usual condition for this is said to be a majority voting interest, and no other examples are given (paras 1 and 2). This is reinforced by the title of SFAS 94,

Consolidation of All Majority Owned Subsidiaries. As a result, certain[8] controlled investees are not seen as entities to be consolidated. Here, the equity method seems a useful fallback position.

In Australia, the matter of equity accounting was first officially raised by the accountancy bodies in 1970 in the context of the de-consolidation of loss-making subsidiaries (Zeff, 1973, p. 39; Walker, 1978b, p. 107; Gordon and Morris, 1996, p. 161). The equity method is not now used as a substitute for consolidation, because no exclusions from consolidation are allowed[9] (AASB 1024). Its use for other purposes in Australia is examined later.

The original International Accounting Standard in this area (IAS 3 of 1976) derives from a study by the Accountants' International Study Group (1973) which noted (para. 47) the use of the equity method for excluded subsidiaries. The IASC's E3 (of 1974) had proposed (para. 31) to require the method for exclusions on the ground of temporary control, but IAS 3 required its use instead as a substitute for consolidation where dissimilar subsidiaries were optionally not consolidated (para. 40). The current standard (IAS 27) no longer allows dissimilar subsidiaries to be unconsolidated. However, it does continue to require (para. 13) exclusion from consolidation when (and only when) control is temporary (and the investee has never been consolidated) or when there are severe long-term restrictions on the transfer of funds to the parent. In such cases, reference should be made to IAS 25 on investments (or from 2001 to IAS 39), which does not allow the equity method. Perhaps this is reasonable, as there is no long-term significant influence.

In the U.K., SSAP 14 (of 1978) contained the earliest requirement for the use of the equity method for subsidiaries excluded from consolidation for reasons of dissimilarity or lack of effective control (paras 23 and 24). Subsequent law[10] confirmed this. Thus, the equity method acted as a safety net for the partial inclusion of companies that were controlled but were 'off balance sheet' due to the lax U.K. definition[11] of a subsidiary in the U.K. until the Companies Act 1989. The requirement is retained by FRS 2 (of 1992) for subsidiaries excluded on the grounds of dissimilarity (para. 30), although such cases are said to be exceptional (para. 25(c)). Support for this exclusion and for the concomittant use of the equity method seems to come from the EC Seventh Directive.[12] Consequently, it can be found in

[8] The SEC has a somewhat broader notion, including special purpose entities. EITF 90–15 also goes somewhat further.

[9] 'Temporary' exclusions are not allowed; the existence of severe restrictions on ability to control implies that the investee is not a subsidiary.

[10] Companies Act 1981; re-enacted as Sch. 4, para. 65(1) to the 1985 Act; then, in 1989, relating to dissimilarity, as Sch. 4.A, para. 18.

[11] The definition was expressed (Companies Act 1985, s. 736) in terms of control of the composition of the board (not votes on the board), or ownership of the majority of equity (not of voting equity). This gave rise to the possibility of 'controlled non-subsidiaries'.

[12] Reference in Article 14 (1) (on exclusion) is made to Article 33 (on the equity method).

the laws of other member states (e.g., Germany: *HGB*, §295 (1)[13]; Italy: *Decreto Legislativo 127*, Art. 36; Sweden: Annual Accounts Act 1995, Chapter 7, Section 23).

SEMI-CONSOLIDATION

So far, there has been concentration on three types of use of the equity method for the treatment of subsidiaries, as summarized in the first column of Table 1. Another use of the equity method is in consolidated statements (and sometimes in investor statements) for certain investees other than subsidiaries. Here the rationale for the equity method as a form of semi-consolidation or of valuation is less clear than above, as will be explored in a later section, after a discussion of some definitional points and an outline of international practice.

Scope

The major issue here is to identify the nature of the non-subsidiary investees for which equity accounting would be a suitable treatment. It is clear that, in the U.K. and the U.S., joint ventures were originally much in mind. The first exposure draft (in 1970) of the U.K.'s Accounting Standards Steering Committee (ASSC)[14] was on the subject of equity accounting, for reasons explored below. It defined an associated company as a joint venture or a company in which there is a substantial interest '(i.e. not less than approximately 20 per cent of the equity voting rights)' (para. 6).

TABLE 1

USES OF EQUITY METHOD

	Subsidiaries	Joint ventures	Associates
Investor statements	I *Proto-consolidation* (e.g., U.K. and U.S., early 20th century) II *Pseudo-consolidation* (e.g., Netherlands)	III *Pseudo-consolidation* (e.g., Netherlands)	IV *Pseudo-consolidation* (e.g., Netherlands)
Consolidated statements	V *Substitute consolidation* (e.g., U.S. if no majority votes; formerly for foreign subsidiaries and dissimilar subsidiaries)	VI *Semi-consolidation* (e.g., U.S.; and EU Directive and IAS 31 when not using proportional consolidation) (Note the use of gross equity method in U.K.)	VII *Semi-consolidation* (e.g., U.S. and EU) (Note former Australian use of disclosures based on equity method for this Case and Case VI)

[13] Ordelheide and Pfaff (1994, p. 177) suggest that it is also appropriate for optionally excluded subsidiaries (e.g., limitations on control).

[14] Established in 1970 and later re-named the Accounting Standards Committee.

Commenting on the development of the U.K. standard, Leach (1981, p. 6) states that 'the existence of consortium companies, controlled by no single corporate body, was very much in point' and that the definition 'emerged as the concept of partnership, recognition of substantial interest . . . and ability to exercise substantial influence'.

The U.S. statement of 1971 on the equity method referred to 'joint ventures and certain other investments in common stock' (APB Opinion 18, para. 1). Thus, there are two categories in the original U.K. and U.S. statements, but joint ventures come first, and the others are to be treated in the same way.

In some other jurisdictions (e.g., Australia, France and now in the U.K.), a clear separation of joint ventures from associates is made. It leads to the possibility or the requirement that joint ventures and associates are treated differently. The rest of this section considers the use of the equity method for associates in consolidated and investor statements. In the following two sections, more detail is added to the above outline of the definition of an associate, and the special treatments for joint ventures are considered.

Recommendations and Requirements for Consolidated Statements

This subsection looks at the treatment of associates in consolidated financial statements. It is followed by a note on treatments in investor statements. The requirement to use the equity method for associates (defined then as including joint ventures) in consolidated statements can be found in the U.K.'s SSAP 1 (of January 1971). This followed 'extensive developments' in the 1960s of holdings in associates (Shaw, 1973, p. 176) and a brief period of experimentation with the method by some British companies (Accountancy, 1970b). Tweedie (1981, p. 171) reports that the ASSC stated that only nine out of a survey of 300 major companies for 1968[15] went beyond accounting for dividends received. However, this had risen to twenty for 1969 (ICAEW, 1971); and it included some very important companies (e.g., GEC and Dunlop). Incidentally, Tweedie suggests that the equity method was therefore 'not a subject of great controversy' (p. 171) and that it was chosen as the ASSC's first topic partly because the ASSC had inherited work-in-progress for a draft Recommendation from the Institute of Chartered Accountants in England and Wales. By contrast, the first chairman of the ASSC suggested that the topic was 'a highly controversial one', chosen because of varied practice (Leach, 1981, p. 6). The controversial aspect is backed up by an editorial in *The Accountant* (1970) and, in retrospect, by Sharp (1971). Perhaps these views are reconcilable by noting that the subject was not controversial *before* ED 1 but that the ASSC's proposal *caused* a controversy.

Of relevance here are several observations by Napier (1999). There are at least two reasons why the ASSC's first chairman (Sir Ronald Leach) would have been interested in this topic. First, Leach was one of the inspectors appointed by the government in September 1969 to investigate Pergamon Press which had not shown

[15] Tweedie and the survey's title refer to 1968–9, but that is largely to include a few companies with year ends in early January 1969.

its share of a large 1968 trading loss in its consolidated profit and loss account because it was not using equity accounting for its 50 per cent interest in a company (Napier, 1999, pp. 6, 12, 14, 17). Second, Leach's most important audit client, Rank Organisation, had a 49 per cent interest in a company that carried out the group's most important operations, Rank Xerox.

Similar U.S. requirements on equity accounting date from very slightly later: APB Opinion 18 of March 1971. In some other countries, recommendations can be found in the 1960s. In France, a ministerial decree of 20 March 1968 (Beeny, 1976, p. 147) referred to methods used in group accounts, including full consolidation (*intégration globale*), proportional consolidation (*intégration proportionnelle*) and equity accounting (*mise en équivalence*). The equity method was recommended for companies in which the investee held more than 33.3 per cent of the equity and which were neither subsidiaries nor joint ventures. There was further official encouragement from the Conseil National de la Comptabilité (CNC, 1973).

In the Netherlands, the non-governmental[16] Hamburger Report of 1962 recommended a version of the equity method ('intrinsic value', see above) for 'participations' (*deelnemingen*), which are long-term significant holdings where the business of the investor and investee are similar (Zeff *et al*., 1992, p. 135). This would include joint ventures. The governmental Verdam Commission reported in 1964, recommending particular disclosures (although no particular accounting method) for such investments, defined as holdings of 25 per cent or more (Zeff *et al*., 1992, p. 154). The first exposure draft of the Tripartiete Overleg[17] in 1971, following soon after U.K. and U.S. drafts, also preferred a version of the equity method for participations (Zeff *et al*., 1992, p. 207).

This growing international consensus led to the inclusion, in the IASC's E3 (of 1974) and IAS 3 (of 1976) and in the EC Seventh Directive (drafts of 1976 and 1978, and Article 33 of the final version of 1983), of requirements for the use of equity accounting for associates in consolidated statements. The requirement in the Directive also explicitly covers joint ventures unless proportionally consolidated (see later). Some European countries had held out against the equity method until they were overwhelmed by the Seventh Directive. For example, in Germany, the concept of the group in the 1965 *Aktiengesetz* was based on uniform direction (*einheitliche Leitung*), which survives as an optional basis for the definition of a subsidiary in the Seventh Directive (Art. 1 (2)). On this conceptual basis, since associates are not managed on a unified basis with the investor (because they are not controlled) and so they are not group companies, they had to be accounted for on a cost basis. Although German influence was clear on many issues in the first draft of the Seventh Directive, the Germans had little support on this point and the equity method for associates was proposed as compulsory from the beginning (Diggle and Nobes, 1994, p. 324).

[16] Set up by the Council of Dutch Employers' Federations.

[17] Tri-partite committee; the predecessor of the Council for Annual Reporting (Raad voor de Jaarverslaggeving).

In Sweden, the equity method was regarded with suspicion from a legal standpoint in the early 1980s. The doubt concerned whether the equity method was a legally acceptable valuation method.[18] A few large groups used it in consolidated statements but most did not (Cooke, 1988, p. 62). Legal doubts were partially resolved by considering the equity method as a form of consolidated rather than as a valuation method. The equity method was proposed for consolidated statements by the then standard-setting body (FAR) in 1986 (Heurlin and Peterssohn, 1995, p. 1997) before becoming legally required on implementation of the Seventh Directive in the Swedish Annual Accounts Act of 1995 (Chapter 7, Article 24).

Outside of Europe, the most sceptical country has been Australia. A series of exposure drafts (1971, 1973 and 1979) recommending equity accounting began to be issued soon after those in the U.K. and the U.S. However, these met problems. First there was an impediment arising from a legal interpretation of the Victorian Companies Act 1971 that group accounts should encompass only the holding company and subsidiaries and therefore not equity-accounted earnings. Gordon and Morris (1996, p. 166) explain how the legal debate began in 1972 and continued for years. The legal impediment is also discussed by Eddey (1995, p. 303) and Vallely *et al.* (1997, p. 17). There were also, in the 1980s, abuses of the equity method. For example, some effectively controlled entities were equity-accounted instead of being consolidated, and some investees not subject to significant influence were equity-accounted (Ma *et al.*, 1991, pp. 204–8). Consequently, the standard setters eventually limited the use of the equity method to disclosures based on it (Ma *et al.*, 1991, p. 191). Some Australian groups showed an extra column in their consolidated financial statements on an equity-accounted basis (Deegan *et al.*, 1994).

Just as the legal and conceptual doubts of Germany and Sweden seem to have been swept aside by majority international practice rather than by clear arguments, even Australia amended AASB 1016 in 1998 to require equity accounting, following the removal of the legal impediment and a commitment to harmonization with IASC standards (Peirson and McBride, 1997). To avoid a conflict with the Australian conceptual framework (which clearly places associates outside the group reporting entity) and the consolidation standard, equity accounting is said to be a valuation method rather than a consolidation technique (Miller and Leo, 1997). This is up-side down compared to the reasoning in Sweden (noted above), although it fits the Dutch view.

Associates in Investor Statements

In most countries examined here, associates (like subsidiaries) are valued at cost in investor financial statements. However, in those countries where pseudo-consolidation (or valuation) is used for subsidiaries in an investor's statements, it is generally extended to associates and joint ventures. Otherwise, the objective of making the group equity equal to the investor's equity is not achieved.

For example, in Denmark and the Netherlands, the equity method is used in the investor's statements for associates and joint ventures. This appeared to be in conformity with the Fourth Directive, where Article 59 allowed such treatment for

[18] I am grateful, here, to Rolf Rundfelt of KPMG, Sweden.

an undefined category of 'affiliated undertakings'; and this was clarified by an amendment in Article 45 of the Seventh Directive which refers to significantly influenced undertakings. In the U.S., the equity method was also originally required in parent statements for those investments that were equity accounted in consolidated statements (APB Opinion 18, para. 17). It is presumably now allowed despite the amendments to SFAS 94 (see the earlier section on pseudo-consolidation). It is also allowed by IAS 28 (paragraph 12). In the same way as for subsidiaries, the method is allowed for associates in France and Italy (but not used), and is not allowed in the U.K. or Germany.

MORE ON THE DEFINITION OF AN ASSOCIATE

The UK Origins of the 20 Per Cent Threshold

U.K. and U.S. rules (SSAP 1 and APB Opinion 18, both of 1971) basically defined associates[19] as those over which the investor exercises a significant influence over operating and financial policies (SSAP 1, para. 13; APB Opinion 18, para. 17). This is the definition followed by the EC Seventh Directive of 1983 (Article 33 (1)), and therefore found in many European national laws.

However, this is a much vaguer concept (and more difficult to audit) than even the concept of 'control' which is the basis of the definition of a subsidiary in many jurisdictions. Consequently, it is difficult to operationalize (Chambers, 1974) and guidance is needed if standardized practice is to result. Part of the guidance comes in the form of a numerical threshold of the percentage of shares (or voting shares) to be held. In some jurisdictions, the threshold appears to be of a mechanical nature; in others it is hedged around with rebuttable presumptions. This point will be considered after the *size* of the threshold has been examined. The emergence of an internationally agreed threshold of 20 per cent of voting shares seems to have been accidental, as will now be charted.

There is a long history of separately identifying non-subsidiary investments above a certain size of holding. For example, in the U.K., the Companies Act 1947[20] designated certain holdings as 'trade investments'. According to Shaw (1973, p. 175), these: 'may be taken to be investments made to cement a trading relationship or for specific purposes associated with the trade of the investing company'.

Recommendation N 20 (ICAEW, 1958, para. 41) also required disclosures relating to material, but undefined, 'associated companies'. The Companies Act 1967 (s. 4) was more precise and required some non-financial disclosures where an individual investor held more than 10 per cent of equity[21] in an investee. Also, the London Stock Exchange Listing Agreement required, at least from the first 'Yellow Book' of 1966, disclosures about so called 'associated companies', defined

[19] APB Opinion 18 does not use this term, although it can be found in U.S. literature (e.g., Neuhausen, 1982, p. 55).

[20] Consolidated as paras 8(1)(a) and 12(1)(g) of Schedule 8 to the 1948 Act.

[21] Or where the book value of the shares was more than 10 per cent of total assets.

originally as those in which the investing group held more than a certain threshold level of equity. Shaw (1973, p. 176) suggests that this was a significant precedent for the ASSC's work because of the use of the term 'associated company' and the reference to total group holdings rather than to investor holdings. These two points distinguish the Stock Exchange's requirement from previous company law or tax law. Shaw (1973, p. 176) also states that the Listing Agreement uses a 20 per cent threshold, which would seem to clinch the argument about the source of the definition. However, the Yellow Books of June 1966 and of April 1969 use 25 per cent in their definitions.[22] This threshold is noted in the ICAEW's survey of 1970–71 (ICAEW, 1972, p. 13). An amendment to the Yellow Book, to reduce the threshold from 25 per cent to 20 per cent holdings, was published in June 1972, which puts it *after* SSAP 1, suggesting that the latter influenced the stock exchange, rather than the other way round.

In the U.K., the ASSC's first exposure draft (ED 1) of June 1970 had already used a threshold of 20 per cent (para. 7). No explanation is given for this level in the exposure draft.[23] There are no references to the origins of the 20 per cent threshold in the archives[24] of the ASSC or in the current memories of participants[25] in the debates. There are several comments on equity accounting in the accountancy journals[26] of the day (Titcomb, 1970; Goch, 1972), but only one can be found with any explanation of the 20 per cent: MacNair (1970, p. 367) notes that, under tax law of the time, a consortium that could share tax losses was one where equity participation was held by five or fewer companies. It was suggested that 'common interest' would be implied where such consortium relief was used.

A survey of tax and company law literature fails to reveal any other convincing source of the 20 per cent threshold. In U.K. tax law, thresholds of 10, 50 and 75 per cent can be found (Lamb, 1995, p. 37). The Companies Act 1948 had contained various thresholds other than 20 per cent; for example, 10 per cent relating to an extraordinary general meeting (s. 132(1)), 15 per cent relating to variation in rights and alteration of memorandum (ss. 72(1) and 5(2)), and 75 per cent for special resolutions (s. 141(1)).

The practices of the few British companies who used equity accounting before ED 1 may have been influential. Grand Metropolitan in its 1967 accounts reported on a number of associates held from 28 per cent to 50 per cent. A comment in

[22] Schedule VIII, part A, para. 6(c), note (i): 'For the purpose of this Undertaking "associated company" means a company which is not a subsidiary but in which 25% or more of the equity is held by the company or, if the company has subsidiaries, by the group companies collectively (i.e. before excluding any proportion attributable to interests of outside shareholders in the subsidiaries).'

[23] Reprinted in *Accountancy*, July 1970, pp. 496–8.

[24] I am very grateful to Michael Mumford (letter to me of 29 June 1998) for examining the relevant minutes of the ASSC in the John Rylands Library.

[25] I have corresponded with Harold Edey, Michael Renshall and Chris Westwick.

[26] The author has examined contemporary issues of *Accountancy*, *The Accountant's Magazine*, *The Accountant* and *The Journal of Accountancy*.

Accountancy (1970a) presumed a threshold of 25 per cent, which had been used by Dunlop and by William Cory in their 1969 accounts. Other companies stressed a relationship rather than a specific threshold (Holmes, 1970, pp. 514–18). However, British Ropes adopted a specific 20 per cent threshold for the first time in its accounts issued in early 1970, before ED 1 (Holmes, 1970, p. 515). Other companies (e.g., Delta Metal; see ICAEW, 1971) used the term 'associated' for holdings of above 10 per cent, but only for disclosures not for equity accounting. It seems that the ASSC chose the lowest threshold actually used in practice for equity accounting, beginning its tradition of accommodating companies' wishes.

The Spread of the Threshold

In the U.S., the APB's sub-committee on this subject initially favoured a 10 per cent threshold on the basis of what it called an 'economic interest' interpretation.[27] Some members of the sub-committee[28] and the SEC staff preferred a 25 per cent threshold on the basis of 'presumption of control', particularly over dividend payments. The board, at its meeting of March 1970, changed its position from favouring 10 per cent to 25 per cent. However, at the July meeting, it was noted[29] that the U.K.'s ED 1 proposed 20 per cent and that international coordination would be beneficial (Defliese, 1981, p. 110; Journal, 1970, p. 12). It seems that, even in the first year of operations of the U.K. standard-setter, there was an exchange of exposure drafts with the APB; and in the following year, the APB chairman was in London for discussions (Accountancy, 1971). In October 1970, the board decided on 20 per cent as an internationally coordinated compromise between its two previous views, although the SEC still did not agree.

Thus, on the basis of no clear arguments, the foundations for the eventual worldwide triumph of 20 per cent were laid. In January 1971, SSAP 1 was issued, retaining the 20 per cent. In March 1971, APB Opinion 18 (also containing 20 per cent) was issued. The U.K. press had noted[30] the earlier U.S. change to 25 per cent and then noted[31] the change to 20 per cent. However, in neither case was there any comment about the comparison with the British exposure draft's 20 per cent. This Anglo-American agreement is mirrored in a reference to a 20 per cent threshold in IAS 3 (para. 4) of 1976.

In the meantime, many other thresholds were in use internationally. As explained earlier, 25 per cent was to be found in Dutch proposals from at least 1964, and 33.3 per cent was preferred in France from 1968. However, another strand of

[27] I am most grateful to Steve Zeff for the information in this paragraph. Professor Zeff writes in a letter to me of 8 July 1996 that he has based the information on minutes of the APB sub-committee and reports of Big 8 firms to partners after meetings of the sub-committee.

[28] The sub-committee was chaired by George R. Catlett of Arthur Andersen, but those preferring 25 per cent included representatives from Arthur Young and from Lybrand.

[29] See note 26.

[30] News section of *Accountancy*, November 1970, p. 759.

[31] News section of *Accountancy*, August 1971, p. 431.

French thinking relevant to this issue is the concept of participating interests (*participations*). From the 1966 Companies Law, these are investments of 10 per cent and above, which reminds one of the 10 per cent threshold in the U.K.'s 1967 Act noted earlier. Such investments were, and still are, to be shown separately in an investor's balance sheet in France, and one of the *régimes*[32] for group taxation treats income from such investments favourably. In Italy, a remnant of this survives, in that investments of 10 per cent or more in *listed* companies are treated as associates (Civil Code, Article 2359). This seems to accord with the APB's 'economic interest' concept.

Given the diversity of European views and the ascendancy of Anglo-American practices in the field of consolidation (Diggle and Nobes, 1994), it is not surprising that the EC Seventh Directive contained a 20 per cent threshold from its earliest published version (Article 1 (2) of the 1976 draft). This threshold has now been implemented into the laws of most of the 15 EU member states, and elsewhere in Europe (e.g., Norway, as a member of the European Economic Area). In these cases, previous thresholds for other issues have been ignored. For example, many thresholds are found in tax legislation in Europe, including 5, 10, 25 and 95 per cent (Lamb, 1995, pp. 62–73). The predominant thresholds are 10 and 25 per cent, with 20 per cent appearing rarely.[33] On other issues, German law contained a threshold of 25 per cent for blocking changes to a company's constitution and for the existence of a mutual participation (*wechselseitige Beteiligung*).[34] However, as noted above, the Italian implementation (of 1991) refers to holdings of 10 per cent in the case of listed investees. The Spanish implementation (of 1989) refers to holdings of 3 per cent in the case of listed investees (Article 185 (2), Decree 1564/1989; Gonzalo and Gallizo, 1992, p. 167). These lower thresholds are not mentioned in the Seventh Directive. However, since the Directive states that significant influence is presumed where the investor 'has 20% or more of the . . . voting rights' (Article 33 (1)), a lower threshold is not specifically ruled out.

Further afield, 20 per cent is recommended in Switzerland by the standard-setters (ARR 2 of FER), and it is required in Japan by the rules of the Ministry of Finance (Financial Accounting Standards, IV, 5, 2) and in Korea (Financial Accounting Standards App. II, Art. 15(a)). Although Australia held out for years against the use of the equity method as a valuation or consolidation practice, the 20 per cent threshold was in the first exposure draft of 1971 and continued through to the eventual disclosure standard of 1988 (ASRB 1016). Turning to international standards, IAS 28 (originally of 1988) naturally followed the international consensus of 20 per cent (now in IAS 28, para. 4). Table 2 summarizes the exceptions from the 20 per cent threshold; the last two of which are extant.

[32] The *régime des sociétés mères et filiales*.

[33] For example, the draft EC Parent/Subsidiary Directive of 1969 would relieve withholding taxes at a 20 per cent threshold, although this was changed to 25 per cent in the directive of 1990.

[34] I am grateful to Dieter Ordelheide for pointing out the blocking percentage. The mutual participation is to be found in s. 19 of Aktiengesetz 1965.

TABLE 2

SOME EXCEPTIONS FROM THE 20% FOR THE DEFINITION OF ASSOCIATES

Netherlands	25% in a government report of 1964
France	$33^{1}/_{3}$% in CNC recommendation of 1968
U.S.	10% and 25% in APB discussions in early 1970
Spain	3% for listed holdings in 1989 law
Italy	10% for listed holdings in 1991 law

Rebuttable Presumption

As noted above, the numerical threshold is stated baldly in some rules, particularly those flowing from the Seventh Directive. For example, in Germany (HGB §311 (1)) and in Italy (Civil Code, Art. 2359 (3)), the assumption of significant influence rests squarely on the numerical thresholds, and no qualitative indications are given. In other jurisdictions, the rule-makers appear to have attempted to ensure that financial reporting choices rest on something less mechanical. As noted later, the problem then becomes the vagueness of the rationale for equity accounting. Some rule-makers are clear, at least, that an investor should not be able to treat an investee differently from year to year by buying and selling a few shares around the 20 per cent threshold. Consequently, in the U.S., APB Opinion 18 discusses this in terms of 'considerations' (e.g., representation on the board, and the concentration of other shareholdings) and 'presumptions' (para. 17). The same applies to IAS 3 (para. 4) and IAS 28 (para. 4).

Despite the U.S. attempt to make the threshold less stark, Mulford and Comiskey (1985) found a high concentration of investments in the 16–24 per cent range. Further, affiliates in the 19–19.99 per cent range of ownership reported losses far more often than those in the 20–20.99 per cent range.

The U.K.'s ED 1 (para. 6) contained the threshold of 'approximately 20 per cent'. The 'approximately' was removed for the original SSAP 1 (para. 6), presumably on the grounds of reducing vagueness. However, the 'rebuttable presumption' basis was introduced later (in 1982, para. 14), along U.S. lines. This was strengthened in FRS 9, where there is an extensive discussion of 'significant influence' and it is made clear that this overrides the numerical threshold (paras. 4 and 14–19). Indeed, the 20 per cent is referred to as part of 'companies legislation', suggesting that the reference to a numerical threshold would have been removed but for this. The irony here is that the 20 per cent threshold in the British law was based on the Seventh Directive which was based on the Anglo-American practice which can be traced to a British exposure draft of 1970.

WHAT'S IN A NAME?

It is now appropriate to address a related issue: the origins of the terms 'equity method' and 'associated company'.

Equity Method

'Equity method' is clearly an American coinage, and can be traced back at least to the early 1930s in the context of the arithmetic used for the preparation of consolidated balance sheets (Carman, 1932, p. 103; Dickerson and Weldon Jones, 1933, p. 200). The term can also be found later in the context of 'pseudo-consolidation' in investor statements. This is the case in Noble *et al.* (1941, p. 581) and in Finney and Miller (1952, pp. 343–5); although not in the previous edition of the latter book (Finney, 1946, p. 297). Other terms for the equity method in this context were also in use: for example, 'book value' (Paton, 1943, p. 1073; and Moonitz, 1994, p. 51), 'economic basis of accounting' (Finney, 1946, p. 297); 'book value change basis' (Moonitz and Staehling, 1950, p. 184).

In promulgated GAAP, the term was not initially used; that is, it cannot be found in ARB No. 51 of 1959 (see para. 19). However, it was employed in APB Opinion 10 of 1966: 'This practice is sometimes referred to as the "equity" method' (para. 3). By APB Opinion 18 of 1971 (para. 6), the quotation marks have disappeared. The term was then frequently used by the IASC in IAS 3 of 1976.

In the U.K., acceptance of the term is much more recent. It was not to be found in SSAP 1 (of 1971 and subsequent amendments to 1990). It does, however, appear in the EC Fourth Directive (Article 59 of the 1978 final version, but not the drafts of 1971 and 1974). Since, as noted earlier, the U.K. did not take up the Directive's option in Article 59 to use the equity method in the investor's accounts, the term was not used in the Companies Act 1981 which implemented the Directive. It is used in the Companies Act 1989,[35] though not in the EC Seventh Directive which preceded it (see Article 33). In FRS 9 of 1997 it is well established (e.g. para. 4). In Australia, the term appeared in the two exposure drafts in 1971 and 1974 (see Chambers, 1974).

The terms in French (*mise en équivalence*) and in Dutch (*intrinsieke waarde*) appear to have other origins. The French term seems to refer to the fact that the parent's and group's equity are made equal. The Dutch term refers to the valuation aspect of the method, as noted earlier. Terms in some other languages seem likely to be derived from the American (e.g., the unofficial German terms, *Equitykonsolidierung* and *Equitymethode*).

Associated Company

The term 'associate' (used here to include 'associated company' and similar expressions) is not in universal use in the English-speaking world. For example, it is not to be found in U.S. authoritative literature, which refers to such enterprises elliptically.[36] The term seems to be of British origin but was originally undefined. For example, it was used by Lever Brothers in the 1920s to include subsidiaries. It also has such a meaning in British tax law.[37] It was used vaguely in the ICAEW's

[35] Now paragraph 22 of Schedule 4A to the 1985 Act.

[36] For example, APB Opinion 18 (para. 17) refers to significant influence over an investee. In practice, the equivalent to 'associated undertaking' is an expression such as 'equity accounted investee'.

[37] For example, in the Income and Corporation Taxes Act 1970, s. 302(1), a company is associated with another if one of the two controls the other or both are under the control of the same person.

Recommendation N 20 and precisely (for disclosures) in the Stock Exchange listing requirements of 1966 (see earlier discussion). Companies used the term; for example, Grand Metropolitan in its 1967 accounts (*Accountancy*, 1968) and several others by 1970 (Holmes, 1970; ICAEW, 1971). The term then arrived in accounting standards in 1971 (international standards in 1976) and law in 1989.[38]

The term is not to be found in the Fourth Directive (where the vague 'affiliated undertakings' includes subsidiaries; and 'participating interests' includes those not significantly influenced), but 'associated undertaking' does appear in the Seventh Directive (Art. 33). The English origin seems clear enough in other language versions of the Directive; for example, *geassocieerde onderneming* in Dutch, *enterprise associée* in French, *assoziertes Unternehmen* in German, *impresa associata* in Italian and *sociedad asociada* in Spanish.

The Directive's terms survive into some EU national laws (e.g., German[39] and Spanish[40]) but not all. For example, the Italian code[41] uses *società collegata*, and no terms are used in Dutch[42] or French[43] law, merely references to significant influence.

JOINT VENTURES

Definition

It was noted above that 'semi-consolidation' was initially seen in the U.S. and the U.K. as particularly appropriate for joint ventures, with other associated investees also mentioned. Originally in the U.K. the category 'associate' included the joint venture. However, most jurisdictions now define the terms exclusively, even where the accounting treatment is to be the same.

Early French definitions of the joint venture, including that in a report of the CNC of March 1968 (CNC, 1973; Beeny, 1976, p. 47) refer to a *société fermée* (i.e., one where no shares are held outside of a group of venturers). For an investee to be a joint venture, the investor would have to hold a *participation* (i.e., at least 10 per cent of the shares). Once more, the 10 per cent threshold arises. In APB Opinion 18 (para. 3) the relevant joint venture is 'a corporation owned and operated by a small group of businesses . . . as a separate and specific business or project for the mutual benefit of the members of the group'.

The EC Seventh Directive depicts joint ventures as separate from associates, partly because different treatments are allowed (see below). The Directive's definition of joint venture (Article 32) rests on 'jointly managed'. British law (1985 Act,

[38] The Companies Act 1981 used 'related companies' (e.g., Schedule 4, part I, B) whereas the 1989 Act has 'associated undertakings' (now para. 20 etc. of Schedule 4A to the 1985 Act).

[39] HGB § 311.

[40] Real Decreto 1815/1991, Cap. 1, art. 5.

[41] Codice civile, Art. 2359.

[42] Art. 389.

[43] Art. L357–1.

Sch. 4A, para. 19) follows these words but in FRS 9 'jointly controlled' is used, as follows: 'An entity in which the reporting entity holds an interest on a long-term basis and is jointly controlled by the reporting entity and one or more other venturers under a contractual arrangement' (para. 4).

A similar interpretation has occurred in France, where the Directive says *dirige, conjointement* but the law refers to *contrôle conjoint* (amendment in 1985 to Article 357-1 of the Law of 1966).

In what follows, joint ventures will be assumed to be entities separate from the venturers. For example, IAS 31 (para. 3) distinguishes between jointly controlled 'entities', 'operations' and 'assets'. The latter two categories create few accounting problems because the various assets and liabilities belong to the venturers, so they are included in the financial statements of the venturer (both in the individual entity statements and in the consolidated).

Treatment of Joint Ventures

As noted earlier, in cases where equity accounting is used in an investor's unconsolidated financial statements for subsidiaries and associates (e.g., in Denmark and the Netherlands), then it is also used for joint ventures. This seems to create no difficulty for the Fourth Directive and various laws in the EU because joint ventures fall within the broad categories of 'affiliated' or significantly influenced undertakings. However, there is a difficulty in IAS 31, which specifically deals with joint ventures rather than associates. Strangely, IAS 31 gives no direct consideration[44] to the treatment of joint ventures in the unconsolidated statements of a venturer. That is, there is no equivalent of paragraph 29 of IAS 27 or paragraph 12 of IAS 28. Consequently, although IASs allow subsidiaries and associates to be held by the cost method in investor statements, it appears[45] that IAS 31 does not allow this for joint ventures. This seems to be an oversight.[46]

In consolidated financial statements, the treatment of joint ventures now differs internationally. U.S. and U.K. practice[47] (at least for joint ventures that are incorporated entities) is to use equity accounting on the grounds that there is significant influence but no control. In effect, joint ventures are still seen as a special case of associates, or associates are seen as a less formal type of joint venture. Consistently with this, the equity method is allowed in consolidated statements by the Seventh

[44] Paragraph 38 is deliberately non-committal. David Cairns (IASC Secretary General at the time of IAS 31) confirms that the IASC could not agree on a single practice (letter to me of 7 July 1999). Paragraph 41, despite its heading, relates to particular joint ventures where an investor is not a venturer.

[45] Paragraph 39 requires profit made by selling from an investor to a joint venture (including a joint venture entity) to be eliminated. In practice, this requirement means that the cost method cannot be used. There is no similar requirement in IASs 27 or 28 for an investor selling to a subsidiary or an associate.

[46] The author contacted the IASC on this (9 February 1999), and there is informal acceptance of the problem. But as yet there is no action to amend the IASs.

[47] APB Opinion 18 (para. 16); the Companies Act 1985 (as amended in 1989), Sch. 4A, paras 19–22; and FRS 9 (para. 20) cover this.

Directive and by IAS 31. However, proportional consolidation is also allowed by the Directive (Article 32); and in IAS 31 (paras 25 and 33) it is *preferred* on the grounds that it 'better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity, that is control over the venturer's share of the future economic benefits'. This is despite the fact that the IASC's Framework (para. 49) defines assets in terms of control over the resources not control over the benefits from the resources. It is clear that the venturer does not *control* any of the resources. Consequently, neither the resources nor part of them are assets of the venturer. The same conclusion would be arrived at even if the definition of asset had referred to control over benefits.[48]

The response to the Seventh Directive in France was to *require* proportional consolidation, which was previous French practice. In most EU member states proportional consolidation is allowed. However, this is not the case in Greece, nor in Ireland and the U.K. for corporate joint ventures. It is also not allowed for joint venture entities in Australia (AASB 1006 and 1024 and AAS 19).

In some jurisdictions where proportional consolidation is not allowed, there is nevertheless some concern about the potentially misleading nature of equity accounting for joint ventures. For example, a group would not be required to recognize its share of the liabilities of a 50 per cent held joint venture. One way of responding to this is now used in the U.K., where FRS 9 requires the use of the 'gross equity method' for joint venture entities (paras 20–1). This method, which has a precedent in FASB discussion papers,[49] involves extra disclosures on the face of the consolidated financial statements, including the investor's share of the joint venture's turnover, gross assets and gross liabilities.

The Reporting Entity

This international lack of agreement on the treatment for joint ventures illustrates the need for greater clarity in some conceptual frameworks. The EC Seventh Directive has no explicit framework. The U.S. and IASC frameworks do not discuss the boundary of the reporting entity, and therefore have nothing directly to offer on consolidation issues, although the definition of asset seems relevant, as noted above. By contrast, the U.K.'s later *Statement of Principles* covers the 'reporting entity'. The boundary of the group rests on control (para. 2.6) which puts joint venture entities outside the group and therefore proportional consolidation should not be used (para. 8.9). There was a similar conclusion on the status of joint venture entities in the earlier Australian concepts statement, SAC 1.

RATIONALES FOR THE EQUITY METHOD

Although the equity method is now used for various purposes in much of the world, the rationales for this are not well explained. The seven cases in Table 1 are examined here.

[48] Because the definition would mean control over the services provided by the asset, not control over a share of net profit. A venturer does not control these services.

[49] I am grateful to Janie Crichton (the ASB's project director on FRS 9) for this information.

In the context of the treatment of subsidiaries in an investor's unconsolidated financial statements, the rationale for proto-consolidation (Case I) has been overtaken by the development of full consolidation. Possible rationales for pseudo-consolidation (Case II) include that the equity method is a form of accruals accounting rather than the cash accounting used by the cost method (Neuhausen, 1982, p. 62). This seems inconsistent with the realization convention but, given that Case II relates to subsidiaries, one could try to support it with a substance over form argument. Several such arguments of U.S. writers were examined earlier. A doubt, which did not concern early U.S. writers, could be raised for foreign investees where there might be uncertainties connected to the transfer of funds and the exchange rate.

A similar rationale for the equity method is that it is a form of valuation. The link is made in an Australian exposure draft where equity accounting is seen as 'a method of accounting, on an accrual basis, . . . thereby ensuring improved reporting on the worth of particular investments to the investor' (ASA/ICAA, 1973, para. 19). This seems to be inconsistent with the historical cost convention used in most countries, though not uniformly in some countries (e.g., Australia and the Netherlands).

For investees other than subsidiaries, pseudo-consolidation in investor statements (Cases III and IV) seems even less convincing. The substance over form argument no longer applies, as the investor controls neither the assets of the investee nor its dividend decisions. The profits of the investee (in excess of dividends) are not within the control of the investor. The basis for a threshold at 20 per cent is also unclear, particularly since the 'intrinsic value' of all investments changes as profits are made. Further, as pointed out by Paton (1951, p. 46) and discussed (along with other criticisms of the equity method) by Zambon (1996, pp. 220–5), there seems little economic significance in the 'values' arrived at by the equity method. So, the method is not a conceptually impressive way of valuing, and 'fair value' would now seem more relevant (e.g., IASC, 1997). Nevertheless, a possible defence of the method in the context of the general use of fair values would be that fair value cannot always be reliably measured (e.g., for some unlisted securities) and that large blocks of shares could not be sold at apparent market value. Of course, a large block of shares does have a fair value, although it may be more difficult to identify.

For the above Cases II to IV, the usefulness of making the parent's income and equity the same as the group's is unclear, unless the parent statements are merely unpublished worksheets.

Turning to consolidated statements, the rationale for substitute-consolidation (Case V) has also been overtaken by events in jurisdictions where all controlled investees must be consolidated. For uncontrolled investees (Cases VI and VII), the equity method could be seen again as a method of valuation, whereupon the above points on that topic apply. It could also be seen as a form of semi-consolidation. However, just as the investor does not control the investee's assets, profits or dividend decisions, neither does the group. A basic question here is: Are such investees part of the investor's group? As noted above for joint venture entities,

the answer in the Australian and British frameworks is that they are clearly not. Elsewhere, the answer should be the same if the scope of the group is either based on control or majority ownership, as is the case in the U.S. (ARB 51, para. 2), the European Union (Seventh Directive, Article 1) or the IASC (IAS 27, para. 6). It seems difficult, then, to support the equity method as semi-consolidation on the basis of substance over form.

However, perhaps a rationale can be built around the idea that, above a certain threshold level of interest, the investor is in some form of special relationship with the investee. This approach, which regards associates and joint ventures as much the same, survived into the U.K. Discussion Paper in this area (ASB, 1994) which treated them both as 'strategic alliances' (para. 2.3) to be accounted for by the equity method. Later, FRS 9 (of 1997) rephrases this as follows:

> The investor needs an agreement or understanding, formal or informal, with its associate to provide the basis for its significant influence. An investor exercising significant influence will be directly involved in the operating and financial policies of this associate. Rather than passively awaiting the outcome of its investee's policies, the investor uses its associate as a medium through which it conducts a part of its activities. . . . Over time, the associate will generally implement policies that are consistent with the strategy of the investor and avoid implementing policies that are contrary to the investor's interests. (para. 14)

This clearly interprets the equity method as semi-consolidation, and it rests on joint control of the dividend decision even in those cases where there is not joint control of the individual assets and liabilities. It seems to suit Case VI the best, but might be extended to some associates in Case VII.

TECHNICAL PROBLEMS RAISED BY LACK OF FRAMEWORK

Since the concept behind the equity method and the purpose of its use are unclear, it also becomes difficult to resolve technical issues. Three examples are examined: elimination of profits, presentation in income and cash flow statements, and discontinued operations.

First, when an investor makes a profit by selling to an associate which retains the goods (downstream sales), should some or all of the profit be eliminated from the investor's and the consolidated statements? The profit in the hands of the investor results form an arm's length transaction. It is realized and legally distributable, and therefore should presumably not be eliminated. The same could be said of a profit arising from a sale from a parent to a subsidiary. On consolidation, this latter profit would be eliminated because the subsidiary is part of the group, and the price (and therefore profit) of the sale was controlled by the group. Neither of these points applies to a sale to an associate, which might suggest no elimination, even in consolidated statements.

The Seventh Directive (Article 33 (7)) appears to require elimination but either total or proportional elimination seem to be allowed. In the U.K., FRS 9 (para. 31) states that there should be proportional elimination. The IASC has also recently concluded (SIC Interpretation No. 3) that there should be proportional elimination.

The problem is that, since the theory supporting the equity method is unclear, the theoretical answer on elimination is also unclear.

Another technical point is the location of the equity-accounted elements in income and cash flow statements. The basic issue is whether the amounts are to be classified as operating or as financial. In the EC Fourth Directive (e.g., Article 23, line 9), the profit from participating interests is shown after operating items and as the first financial item. This allows companies to draw the operating line above or below equity-accounted profits. In the U.K., for example, SSAP 1 did not specify the treatment, but FRS 9 (para. 27) requires equity-accounted operating profits to be shown immediately after group operating profit. For U.K. cash flow statements, dividends from associates were originally to be shown as returns on investments (FRS 1 of 1991, para. 19), then as operating activities (FRS 1 as revised in 1996, paras. 11, 14), then as a separate item between the two (FRS 1 as revised again by para. 61 of FRS 9).

The EC Seventh Directive (Article 33 (6)) could be interpreted as allowing a different position for equity-accounted income in consolidated income statements from that required under the Fourth Directive. In France, advantage has been taken of this, so that such amounts are shown after consolidated profit and before minority interests (*Plan comptable général*, p. 11.168). This suggests that such profit is neither operating nor financial.

In the U.S., APB Opinion 18 (para. 19 (c)) is unclear on the location of equity-accounted income. Burnett *et al.* (1979) found that, for twenty-two finance subsidiaries excluded from consolidation, there were five different presentations of the equity-accounted income in consolidated income statements. Modern practice still ranges from presentation as 'other income' before various operating expenses to presentation after minority interests.[50] In U.S. cash flow statements, dividends received form equity-accounted companies are generally included in operating activities (Williams, 1996, p. 4.23).

IAS 1 (para. 75, and appendix) shows equity-accounted profits after operating and financial items in income statements, whereas IAS 7 (paras 31 and 37) allows dividends from equity accounted companies to be treated as either operating or investing items in cash flow statements.

A third technical issue is the presentation of discontinued operations. There are U.S., U.K. and IASC rules in this area. The relevant issue relates to the disposal of some shares in a major subsidiary such that it becomes an associate. Assuming that the subsidiary were large enough to satisfy the size criterion for being a discontinued operation (e.g., FRS 3, para. 4), would the disposal of the shares amount to a discontinuance of the operation by the reporting entity? This issue was a matter for international debate[51] when IAS 35 was agreed in 1998. Since the reporting

[50] For example, General Electric (1996, p. 49) do the former, and General Motors (1997, p. 50 in a supplementary statement) do the latter.

[51] The author was the chairman of the IAS 35 steering committee, and chaired the IASC Board discussion leading to approval of IAS 35 in April 1998.

entity is the group, it would seem that the group has disposed of the operation, and it no longer consolidates any individual assets, liabilities, revenues or expenses. However, the IASC Board decided that is would be consistent with other equity accounting practices to regard the operation as continuing within the sphere of the group's interests. The issue is not directly addressed in IAS 35.

SOME EMPIRICAL FINDINGS

In addition to the many writings referenced above, there has been some empirical research related to the use of the equity method. Mulford and Comiskey (1985) and Burnett *et al.* (1979) have already been mentioned. Another U.S. paper is by Ricks and Hughes (1985) who found a positive market reaction to the first publication of U.S. financial statements using the equity method. The reaction was positively correlated with size of equity earnings and degree of previous underestimate by analysts. This suggested that 'the equity method provided information concerning affiliate earnings not previously available from other sources' (p. 50).

Vallely *et al.* (1997) survey eight studies on equity accounting in Australia. Most of these examine whether management adopts aspects of equity accounting for particular reasons (e.g., attempting to increase management compensation). Mazay *et al.* (1993) suggest that the equity method may be useful in controlling management's behaviour where a material proportion of a firm's assets is in the form of investments in associates. Without the equity method, management might be able to manipulate profit by influencing dividend decisions or by non-arm's length transactions with investees. Similarly, lenders cannot reliably assess borrowers who have material investments in unlisted associates.

Another Australian paper (Czernkowski and Loftus, 1997) suggests that, in the period 1983 to 1990, the equity method provided useful information, particularly when cost-based information was also available.

SUMMARY AND POLICY IMPLICATIONS

The equity method arose as a form of proto-consolidation for inclusion of subsidiaries (or less than fully owned subsidiaries) in parent's financial statements before the practice of consolidation was fully established. Later, the equity method was seen to be unnecessary in some jurisdictions for parent statements. However, in other jurisdictions its sporadic or generalized use is still found, such that the parent's statements contain technically unrealized profits. This pseudo-consolidation can be seen instead as a method of valuation. The term 'equity method' is an American coinage used originally in this context of investor statements. Another formerly widespread use (substitute-consolidation) relates to the treatment in consolidated statements of certain subsidiaries or controlled non-subsidiaries excluded from full consolidation.

These three uses of the equity method for the treatment of subsidiaries (Cases I, II and V of Table 1) seem to be unnecessary or unsuitable:

1. proto-consolidation, because it has been replaced by consolidation;

2. pseudo-consolidation in investor's financial statements, because any form of consolidation seems inappropriate or unhelpful and because there are convincing arguments against using the equity method as a valuation method; and
3. substitute-consolidation, because a control-based concept of the group means that all controlled enterprises should be fully consolidated.

The equity method has also been used for inclusion of joint ventures and associates in investor statements (Cases III and IV: more pseudo-consolidation or valuation) or in consolidated statements (Cases VI and VII: semi-consolidation or valuation). These uses seem to have arisen with little theoretical justification and no prior research into their usefulness. Cases III and IV seem inappropriate for the same reasons as apply to pseudo-consolidation of subsidiaries, and for some extra reasons related to lack of control. This leaves semi-consolidation, which can be divided into two categories: joint ventures (Case VI) and less formal partnerships and other holdings of 20 per cent or more (Case VII). In the U.K. and the U.S., the context for the method originally stressed joint ventures, but other associated enterprises were also included, leading to definitional problems. Terms such as 'associated company' were U.K. inventions of the 1920s onwards.

The arguments for Case VII seem the weaker of the two, particularly where there is no sense of partnership. The concept of 'significant influence' is vague and not easily operationalized; and the 20 per cent threshold is unsupported by argument, having apparently arisen pragmatically in the U.K. and been accepted in the U.S. as a compromise. Where an arbitrary threshold has to be invented in order to operationalize an accounting rule, two features generally occur in conjunction. First, there is a lack of convincing theory and, second, management will try to avoid unattractive financial reporting by making arrangements that fall above or below the threshold, as noted earlier.

An analogy to this aspect of equity accounting for associates is the capitalization of finance leases. The U.S. and U.K. rules[52] contain, *inter alia*, a threshold of 90 per cent of fair value. The German tax rules[53] (and therefore accounting practice) also contain numerical thresholds. These various rules enable management to select leases below the thresholds, which the leasing industry is happy to provide. The U.S. and U.K. thresholds can be seen as an attempt to operationalize the 'substantially all of the risks and rewards of ownership of an asset to the lessee' concept (e.g., SSAP 21, para. 15). However, this has no theoretical basis in any published conceptual framework. When the frameworks' definitions of asset and liability are applied, it becomes clear that all non-cancellable leases meet the definitions, so the arbitrary thresholds are not needed (McGregor, 1996). The U.K. standard setter, in conjunction with others, has begun a project to move in this direction (Nailor and Lennard, 1999).

Applying this analogy to equity accounting, the 'significant influence' concept is difficult to operate, which is why an arbitrary threshold (of 20 per cent) arose.

[52] SFAS 13 (para. 7) and SSAP 21 (para. 15).

[53] See Nobes (1997, p. 64).

However, the concept is not found in the frameworks (except for the U.K.'s recent *Statement of Principles*). Further, it is clear that an application of the frameworks' definitions suggests that an associate is not part of the group and that its profits (in excess of dividends) are not group profits. This all suggests that equity accounting has little theoretical support. If equity accounting were not allowed, we would not need non-operational concepts or arbitrary thresholds. We would also not need to worry about technical problems such as the treatment of profits made on selling to associates.

Overriding all this must be a consideration of the objectives of financial statements. If one accepts the frameworks' objectives, then the issue becomes largely an empirical matter of the best prediction of future cash flows (subject to reliability). In academic writings, there is some justification for the equity method as an approximate valuation method, as a way of reducing agency problems or as a way of providing more information on earnings. However, more research is needed here.

One conclusion is that standard setters should not perpetuate operationally difficult concepts and arbitrary thresholds or group concepts which seem inconsistent with their frameworks unless they can produce evidence that the prediction of future cash flows is enhanced. One way forward would be to require all investments to be shown at fair value, taking gains and losses to comprehensive income.[54] This would replace the equity method with a more honest valuation approach and would remove arbitrary thresholds.

In practice, recent moves towards the use of fair value for investments have deliberately excluded investments in subsidiaries, joint ventures and associates (e.g., SFAS 115, para. 4; and IAS 39, para. 1a). This leads to such delicious ironies as that, under IAS accounting, a 10 per cent holding in a listed company would be held at fair value in the investor's statements, whereas a 25 per cent holding would generally[55] be valued at cost. In the group's statements, the 10 per cent holding would again be fair valued, whereas the 25 per cent holding would be equity accounted. If the latter were seen as a valuation method, it would not be a serviceable one.

Most of the above arguments also apply against using the equity method in the final remaining case: for the treatment in consolidated statements of joint ventures (Case VI) and perhaps other 'partnerships' (those associates most like joint ventures). Theoretical support has to rest on the idea that the investor exercises long-run control over its share of the profits. Another form of support comes from concern that any alternative to the equity method is worse. For example, full consolidation or proportional consolidation of individual assets of a 20 per cent holding in a joint venture or other partnership would be inconsistent with the frameworks' concept of control. At the other extreme, a cost-based method seems to be misleading as a group presentation of an interest in a 50 per cent-held joint venture. Consequently, this last case seems to be the least objectionable use of

[54] 'Comprehensive income' is the term now to be found in SFAS 130. In U.S. terms, whether such gains and losses should be shown in 'income' or 'other comprehensive income' may become a relatively trivial issue as moves are made towards a single income statement.

[55] Assuming, as in many countries, that equity accounting is not used in investors' statements.

equity accounting, and could be seen as semi-consolidation rather than valuation. The U.K.'s 'gross equity method' addresses some of the disclosure problems caused by the netting off involved in the equity method. A report of six English-speaking standard setters (the G4 + 1) concluded in a similar way about the treatment of joint ventures (Milburn and Chant, 1999, p. 25) and makes a supporting reference[56] to an earlier (1998) draft of this article.

The spread of the equity method from one use to another can be seen as part of the response of pragmatic accountants to a series of technical problems: the lack of consolidated statements, then the complications of preparing such statements, then the lack of consolidation of certain subsidiaries, then the lack of consolidation of those jointly controlled investees that were rather like subsidiaries, and so on. The spread of the equity method internationally, despite good arguments against it in several countries, should warn us that the pressures for international harmonization (that are now even stronger than in the period covered in this article) can lead to world-wide use of bad methods as well as good ones. Similarly, the international spread of the 20 per cent threshold illustrates how a pragmatically neat number, once it is supported by the two strongest accounting nations, can prosper in a theoretical vacuum.

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[56] See Milburn and Chant (1999), note 21. This refers to the 1998 draft in the form of a University of Reading discussion paper in accounting, No. 59.

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