

DIRECT CONSOLIDATION

In our example, the gain on absorption is 300 which can be detailed as follows :

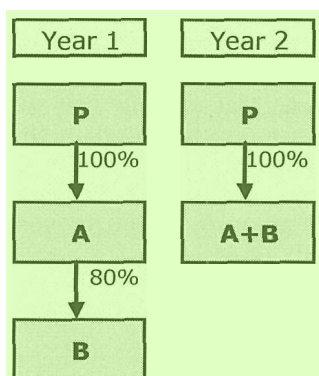
$$300 = 3000 - 2000 - 700 = 1000 - 700 = 100\% * 1000 - 700$$

which represents exactly the consolidated reserves calculated at the end of Year 1!

If we keep the accounts of P as they are and if we go ahead in a consolidation just after the absorption, we obviously will have to face a problem because consolidated reserves for 300 are again booked in the P&L of Year 2 because of this absorption. This cannot be maintained as such and the amount of 300 has to be reversed into Reserves account.

The important message here is that we have to know the result of absorption and the account on which it has been booked in order to reverse the booking correctly.

Description of the absorption case study



Until end of Year 1, parent company P consolidates company A at 100% and indirectly company B at 80%, both with the global integration method.

Beginning of Year 2, company A decides to absorb company B after acquiring from 3rd Parties the remaining 20% of the shares for a price of 200.

Initially, B has been acquired a few years ago with a goodwill of 150 after allocation to a tangible asset for 100 (depreciation 10% per year).

Consolidation – Year 1 ¹

We provide statutory accounts with the consolidation adjustments. ²

P				3
Fin. Inv./A	1,000	Capital	2,000	
		Reserves	1,000	
		Result	300	
Other assets	5,000	Other liabilities	2,700	

A			
Goodwill		Capital	1,000
(a) 150		Reserves	600
Fin. Inv./B	700	Result	200
(a) (150)			
Other assets	3,300	Other liabilities	2,200

B				5
Tangible assets	270	Capital	500	
(b)	100	Reserves	300	
(c)	(30)	(b)	100	
		(c)	(20)	
		Result	(100)	
		(c)	(10)	
Other assets	1,730	Other liabilities	1,300	

Adjustment (a): Goodwill attached to the initial 80% of shares acquired. ⁶

Adjustment (b): Gross value of the asset allocation. ⁷

Adjustment (c): Cumulated depreciations of the asset allocation. ⁸

The consolidated accounts are set up without any difficulty. ⁹

P + A + B				10
Goodwill	150	Capital	2,000	
		Reserves	1,000	
Tangible assets	340	Result	300	
		Conso. Res.(A)	800	
		Conso. Res.(B)	66	
		Minority int.(B)	154	
Other assets	10,030	Other liabilities	6,200	

with ¹¹

- Consolidated reserves (A) = 800 = 100% * [1000 + 600 + 200] - 1000 ¹²

- Consolidated reserves (B) = 66 = 80% * [500 + 300 + 100 + (20) + (100) + (10)] - [700 + (150)] 1

- Minority interests (B) = 154 = 20% * [500 + 300 + 100 + (20) + (100) + (10)]

Some questions before consolidating Year 2 2

In order to prepare the Year 2 consolidation, we should adopt a clear position on the following issues. 3

What about the 150 goodwill? 4

This goodwill concerns company B that disappears because of the absorption. Shall we keep it? To answer this question let's return to some basic principles. A goodwill reflects a kind of additional cost to acquire an economic activity through a company. If it is true that the company disappears from a legal point of view, the group still maintains the activity within the absorbing company. The goodwill is fully justified because, basically, nothing has changed and the absorption is a transaction that should have no effect on the consolidated figures. 5

What about the acquisition of the remaining 20% of shares? 6

The absorption cannot legally be achieved without being owner of the 100% shares of company B. This implies company A has to acquire them and the logic of a goodwill/badwill must be triggered, independently of the fact that there will be an absorption just after the transaction. 7

Supposing we calculate a new goodwill, the normal position is to book it additionally to the former one. It will be our choice. 8

What about the goodwill allocation booked initially in company B accounts? 9

This allocation concerns a tangible asset in company B accounts. After the absorption, the asset is transferred to company A accounts and does not leave the group. Our position is then to maintain the allocation and the historical depreciations adjustments by booking them in company A accounts which becomes the owner of this tangible asset. Priority has to be given to the economical view. 10

And don't forget to reverse the statutory result of absorption 11

As explained above, we should ask company A about the value of that result of absorption and on which P&L account it has been booked. 12

Consolidation - Year 2¹

We present the statutory accounts of each company, including the consolidation adjustments.²

P							
Fin. Inv./A	1,000	Capital	2,000				
		Reserves	1,300				
		Result	200				
Other assets	6,000	Other liabilities	3,500				
A							
Goodwill		Capital	1,000				
(a) 150		Reserves	800				
(d) 46		(a) 150					
		(b) 100					
		(c) (30)					
		(d) 46					
Tangible assets	240	(e) (200)					
(b) 100		Result	(100)				
(c) (40)		(c) (10)					
		(e) 200					
Other assets	6,160	Other liabilities	4,700				

According to our previous explanations, there are five consolidation adjustments to book.⁴

Adjustment (a): We maintain the goodwill of 150 attached to the initial 80% of shares. However, the counterpart is not the financial investment any more but the reserves.⁵

Adjustment (b): We also maintain the gross value of the goodwill allocation in the same way it has been booked in company B accounts before absorption.⁶

Adjustment (c): This allocation continues its economical life in the group (company A) with an additional depreciation.⁷

Adjustment (d): This entry concerns the additional goodwill related to the acquisition of the 20% of shares.⁸ The acquisition price is 200 and the corresponding equity is $154 = 20\% * [500 + 300 + 100 + (20) + (100) + (10)]$, giving a goodwill of $46 = 200 + (154)$. This goodwill being calculated just before the absorption, we consider the Year 1 equity of company B.

DIRECT CONSOLIDATION

Adjustment (e): As we know the statutory accounts of company B just before absorption, we are able to calculate the result of absorption, which is

Net value of tangible assets	270
Other assets	1,730
Other liabilities	(1,300)
Financial investments (80%)	(700)
Financial investments 20%	(200)
	(200)

and we will suppose that loss on absorption has been booked in the P&L.

Here are the corresponding consolidated accounts

P + A			
Goodwill	196	Capital	2,000
		Reserves	1,300
Tangible assets	300	Result	200
		Conso. Res. (A)	956
Other assets	12,160	Other liabilities	8,200

where

- Consolidated reserves (A) = 956 = 100% * [1000 + 800 + 150 + 100 + (30) + 46 + (200) + (100) + (10) + 200] - 1000

Consolidated reserves evolution

	Year 1 reserves	Year 2 result	Dividends	Dividends +	Transfers	Dividends P	Year 2 reserves
P	1,300	200					1,500
A	800	90			66		956
B	66	0			(66)		0
	2,166	290	0	0	0	0	2,456

In Year 1 there are three companies and only two for Year 2. Reserves of company B are just transferred to the reserves of company A.

This case study may look a little bit difficult to solve but, if done correctly, the reserves evolution gives a very clear and comprehensive picture.

4.3 Merge of two companies¹

When two companies, owned at 100% by a parent company, decide to merge, this transaction has no impact on the consolidated figures because it is a non cash transaction with no interaction with the outside world. The economical activity, initially located in two companies, is centralized in a single company but still remains in the group. Of course, all historical adjustments booked in each individual company must be kept and booked in the merged entity.

Contrary to an absorption where we have explained that the statutory result of absorption had to be reversed, there is nothing to book in a merge transaction.

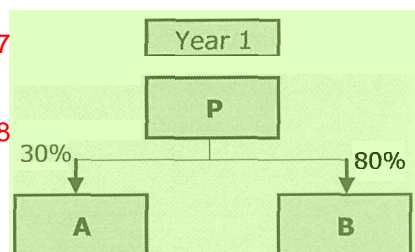
That's for the basic principles.⁴

Unfortunately, some problems arise when the two companies are owned with different percentages and, possibly, with different consolidation methods.⁵

Description of the situation⁶

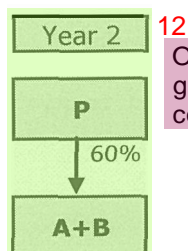
Two companies, A and B, are owned directly by the parent company P.⁷

Company A is owned at 30% and consolidated with the equity method. Company B is owned at 80% and consolidated with the global integration method.⁸



Company A has been acquired a few years ago with a goodwill of 200. Company B has been acquired last year with a goodwill that has been partly allocated to a tangible asset for 1000 (depreciation of 10%/year) leaving a remaining goodwill of 500.¹⁰

Until now, no impairments have been booked on these goodwills.¹¹



On January 1st Year 2, these two companies decide to merge, giving the new following group structure, and just before, company B pays 300 dividends to its shareholders.¹³

DIRECT CONSOLIDATION

To keep further explanations clear we will consider the merged entity A+B as a new company distinct from A and B. In real life, one of the two companies disappears and we remain with the other, even if its name might possibly change.

The new percentage of 60% will be explained later on.

As usual, we propose

- To consolidate first Year 1
- To analyze this merge transaction
- To consolidate Year 2

and we conclude by justifying the consolidated reserves evolution in order to validate the process.

Consolidation – Year 1

Here are the statutory accounts

P			
Goodwill/A		Capital	3,000
(a) 200		Reserves	1,500
Goodwill/B		Result	500
(b) 500			
Fin. Inv./A	1,000		
(a) (200)			
Fin. Inv./B	5,000		
(b) (500)			
Other assets	3,000	Other liabilities	4,000

A			
		Capital	2,000
		Reserves	1,700
		Result	300
Other assets	7,000	Other liabilities	3,000

B			
Tangible assets	4,000	Capital	3,000
(c) 1,000		Reserves	3,000
(d) (200)		(c) 1,000	
		(d) (100)	
		Result	300
		(d) (100)	
Other assets	6,000	Other liabilities	3,700

with the following consolidation adjustments **1**

Adjustment (a): Goodwill of 200 on company A **2**

Adjustment (b): Goodwill of 500 on company B **3**

Adjustment (c): Allocation of company B goodwill for a gross amount of 1000 **4**

Adjustment (d): This amount is depreciated over two years, one 10% depreciation related to Year 0 and booked on the Reserves and 10% depreciation for Year 1 booked on P&L. **5**

Nothing else has to be booked and hereunder are the corresponding consolidated accounts. **6**

P + A + B 7			
Goodwill	700	Capital	3,000
		Reserves	1,500
Tangible assets	4,800	Result	500
		Conso. Res.(A)	400
Equity value (A)	1,200	Conso. Res.(B)	1,180
		Minority int.(B)	1,420
Other assets	9,000	Other liabilities	7,700

where **8**

- Consolidated reserves (A) = $400 = 30\% * [2000 + 1700 + 300] - [1000 + (200)]$ **9**

- Consolidated reserves (B) = $1180 = 80\% * [3000 + 3000 + 1000 + (100) + 300 + (100)] - [5000 + (500)]$

- Minority interests (B) = $1420 = 20\% * [3000 + 3000 + 1000 + (100) + 300 + (100)]$

- Equity value (A) = $1200 = 30\% * [2000 + 1700 + 300]$

Some questions before consolidation Year 2 **10**

Several sets of questions can be raised before going ahead in a consolidation after such a merge. **11**

Concerning the group structure **12**

- We recommend to ask all information about the number of shares and not the percentages. This merge transaction will lead to the creation of new shares for the A+B entity (or the merged company) and **13**

DIRECT CONSOLIDATION

existing shareholders will exchange their A and B shares against A+B shares. 1

- Whatever the new percentage will be, the consolidated accounts after the merge 2

- Either will integrate company A figures because the merged entity is consolidated by the global method 3

- Or company B figures will disappear because we consolidate the merged entity by the equity method. In any case, this merge will lead to a change of structure in the consolidated balance sheet and the P&L.

Concerning the statutory accounts 4

It is important to analyze and understand the statutory accounts before and after the merge transaction. 5

In consolidation, the equity of A+B must be equal to the sum of both equity of A and B. If not, there may be dividends paid before the merge. In some countries, local regulations admit revaluation of assets when making the merge with an impact in the merged equity. If so, such revaluation must be reversed. 6

Concerning the consolidation adjustments 7

The main question is to decide what to do with all the historical adjustments, initially related to companies A and B, which have disappeared. 8

On the basis of our example, we recommend the following 9

Goodwills must be maintained. Moreover, we recommend keeping them separate even if we don't have two companies anymore but only a single one. Why? Because if in the future company A+B sells the activity related to the former A company, the goodwill attached to it should be eliminated. 10

- Revaluation of assets, and in a more general context, all adjustments booked in the two companies must be kept in the merged company in the same way that would have been the case in the individual companies. 11

Merae analysis : The new percentage 1

We present hereunder the number of shares issued in each company and the corresponding value of the equity in order to evaluate the value of one share.

	Total equity	#shares issued	Value/share
Company A	4,000	2,000	2
Company B	6,000	1,500	4
Company A+B	10,000	1,000	10

Notice that company B equity is 6000 and not 6300 because of the dividends of 300 that will be paid to the former shareholders. This means that parent company P will receive $240 = 80\% * 300$ during Year 2.

From this information, we can easily conclude that shareholders of A exchange 5 shares against 1 A+B share and shareholders of B exchange 5 B shares against 2 A+B shares.

In consequence, parent company P receives 120 A+B shares for its $600 = 30\% * 2000$ A shares and receives 480 A+B shares for its 1200 B shares, giving a final percentage in company A+B of $60\% = (120 + 480) / 1000$.

Merge analysis : The statutory accounts 7

As shown in the report above, the total equity of both companies A and B is $4000 + 6300$ less the 300 dividends, which is equal to the opening equity of company A+B.

Moreover, it is important to notice that

$$30\% * 4000 + 80\% * 6000 = 1200 + 4800 = 6000 = 60\% * 10000$$

meaning that the exchange of shares is fair for all shareholders.

And so, shall we get some problems in the next consolidation? Unfortunately yes because if the exchange of shares is "fair" when considering the statutory equity, it becomes "unfair" in consolidation because there are some adjustments impacting the equity.

We will come back to this problem when considering the Year 2 figures.