

4.2 How to explain variations?¹

The problem is quite simple and we can give a general approach for a² "conceptual" account because it will apply to any other equity or financial account.

We will see that only the financial nature of the variation, depending of the³ account, will have to be stored in an appropriate column of the status board.

Suppose that the minority percentage for Year 1 is p₁ and for Year 2 is p₂. p⁴ or p₂ may be 0%, depending on the consolidation method or the fact that we consider a global integration company owned at 100%.

We now consider one equity amount M₁ in Year 1 and M₂ in Year 2, with a⁵ variation V. Of course, we can write M₂ = M₁ + V. This situation can apply to any account. V could be a capital increase, a dividend paid, a translation adjustment variation, an increase of grants, ...

The consolidation process calculates Minority interests respectively equal to⁶ M₁ * p₁ for Year 1 and M₂ * p₂ for Year 2 and we are interested in explaining the variation

$$M_2 * p_2 - M_1 * p_1 = (M_1 + V) * p_2 - M_1 * p_1 = M_1 * (p_2 - p_1) + V * p_2^7$$

where we see that the net variation always consists in two components⁸

- The first component showing the percentage variation p₂ - p₁⁹ between Year 2 and Year 1 in the opening value M₁ of the account
- The second component showing the Year 2 percentage p₂ in the variation.

Let's just see what we get with this formula considering a capital increase in¹⁰ the following example

	Year 1	Capital increase	Year 2
Capital	100	40	140
Minority %	30%		20%
Minority interests	30		28

where we can see that the variation of Minority interests to justify is (2).¹²

The status board would mention the following two elements¹³

- A variation in the opening amount for $100 * (20\% - 30\%) = (10)$ ¹⁴

And $20\% * 40 = 8$ corresponding to the part of the 3rd Parties in the 1 capital increase.

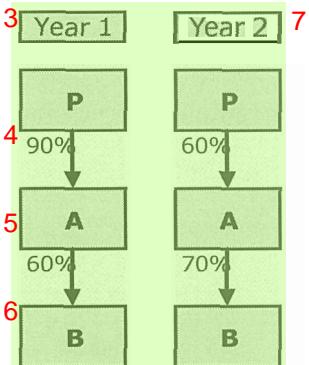
4.3 Case study 2

In this group, we are going to produce a justification 3 of the Minority interests evolution for companies A and B which is a foreign company.

For Year 1, the 3rd Parties percentages are 10% in A 4 and $46\% = 100\% - 90\% = 60\%$ in B.

For Year 2, we find 40% in A and $58\% = 100\% - 60\% = 70\%$ in B.

Moreover, we will restrict our view on the necessary 6 accounts, without making a complete consolidation.



Here are these accounts 8

Company A	Year 1	Capital increase	Approp.	Divid.	Result	Shares disp.	Year 2
Fin. Invest./B	80					30	110
Capital Reserves	200	100					300
Result	160		10				170
	30		(10)	(20)	10		10

Company B	Year 1	Capital increase	Approp.	Divid.	Result	CTA variation	Year 2
Capital Reserves	100						100
Result	60						100
Trans. Adjust.	40		40				30
	30		(40)		30	20	50

Let's first calculate Minority interests in the usual way of a consolidation 11 process.

For Year 1 12

- Company A : $31 = 10\% * (200 + 160 + 30 - 80)$ 13
- Company B : $105.8 = 46\% * (100 + 60 + 40 + 30)$

For Year 2 1

- Company A : $148 = 40\% * (300 + 170 + 10 - 110)$ 2

- Company B : $162.4 = 58\% * (100 + 100 + 30 + 50)$

The status board to be built will contain the necessary number of columns, 3 depending on the different variations we feel useful to show.

In our example, we have noticed result of the year, increase in capital, 4 payment of dividends, shares acquisition, translation adjustment account and percentages variations.

Here is the status board for which we provide comments hereunder 5

	Year 1	Result	Divid.	Capital increase	CTA	Fin. Inv. acquisition	Var. %	Year 2
A	31	4	(2)	40			87	148
B	105.8	17.4			15.2	(12)	24	162.4

Result 7

- Company A : $4 = 40\% * 10$ 8

- Company B : $17.4 = 58\% * 30$

Dividends 9

We will suppose parent company has disposed its 30% company A shares by 10 keeping the rights on 90% of the dividends. This implies 3rd Parties will receive 10% of these dividends besides the fact they have now 40% a participation in A.

This means a dividend of $(2) = 10\% * (20)$. It is important to notice that we 11 won't find a compensation of 2 in another column. We are not consolidating the 3rd Parties group and we only act a decrease of their interests.

Capital increase corresponding to $40 = 40\% * 100$ 12**CTA** includes two components 13

- First component on the opening: $3.6 = 30 * (58\% - 46\%)$ 14

- Second component on the Year 2 variation: $11.6 = 20 * 58\%$

giving a net variation of 15.2. 15

Fin. invest. acquisition for 12 = 30 * 40%. This amount is written as negative 1 in the status board because it is an asset (debit) netted on a liabilities account (Minority interests).

Var.% is the impact on variation percentage on opening amounts. 2

- Company A : 87 = $[200 + 160 + 30 - 20 - 80] * [40\% - 10\%]$ 3
- Company B : 24 = $[100 + 60 + 40] * [58\% - 46\%]$

A particular attention must be brought to the equity of company A which 4 includes the amounts of Year 1 less the dividends paid, processed separately. Financial investment must also be included in the calculation with the correct sign.

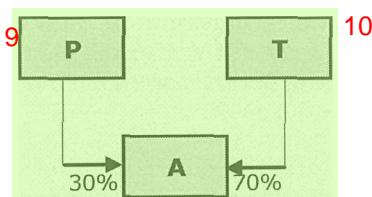
We cannot help noticing that this status board requires a huge arithmetical 5 effort for a weak interest from an accounting or financial point of view.

Could it be sometimes a requirement from Auditors to test the capability of 6 the consolidator and check how he is able to master his consolidation?

5 EVOLUTION OF PARTICIPATION AT 7 EQUITY VALUE

5.1 When Equity value and Minority Interests 8 are the two sides of the same mirror

The company A, owned by parent company P 9 at 30%, is consolidated with the equity method. The other shareholder, company T considered as 3rd parties, owns the remaining 70% and, if required, would consolidate company A with the global integration method.



In its consolidated balance sheet, we would then find Minority Interests 11 related to company A for an amount equal to 30% of its equity valued at the closing date.

But this valuation is exactly the same as the one that would be used in the 12 consolidation of company P when applying the equity method to company A at 30%. If we suppose both P and T are consolidating with the same rules and

with no adjustments booked in A, Minority interests and Equity value would 1
be equal.

This means that the methodology explained to justify Minority interests 2
evolution can be reused exactly in the same way to justify the evolution of
equity method participations.

The columns of the status board will also be non standard and adapted 3
depending on the nature of the equity accounts and their evolution.

THE CASH FLOW STATEMENT⁴

6.1 About the cash flow statement and its⁵ utility

Difficulties to understand some variations by considering only the⁶
consolidated balance sheet

The only consideration of the closing amounts of two periods in a consolidated⁷
balance sheet does not allow to understand the policy of investment or
financing of a group.

The risk of wrong conclusions is very likely.⁸

For example, the increase of an account such as stocks can of course be the⁹
consequence of bad decisions at management level.

But the acquisition of new companies and their global or proportional¹⁰
integration in the consolidation scope will have the same effect while, maybe,
for the existing companies in both periods stocks may be managed with a
good efficiency.

Moreover, the only change of consolidation method will also provoke a failure¹¹
to understand these evolutions correctly.

Finally, an important jump of an exchange rate will lead to the same¹²
consequence.

To face these difficulties, the notes to the accounts will certainly help for a¹³
better understanding, but generally these notes concern mainly non current
assets and some of the non current liabilities.

Because of the consolidation process, important information is also rather¹⁴
difficult to find such as

- The price paid to acquire a new company that cannot be deducted from the consolidated balance sheet because that item is eliminated 1
- The contribution of the 3rd Parties in the increase of capital of a company is also impossible to evaluate
- The same can be said for the dividends paid by group companies to 3rd Parties

and more generally, how to analyze correctly the use of cash in a group? 2

The only acceptable answer to that question is the "Cash Flow Statement" 3

The cash flow statement 4

The basic idea behind the cash flow statement is to explain how a group 5 managed its cash with the outside world all along the consolidation period.

There is no standard format for the cash flow statement but, beyond this 6 problem of presentation, all groups consider three main categories, namely cash related to

- Operating activities 7
- Investments and disinvestments
- Financial transactions

The information necessary to build a cash flow statement comes from some 8 P&L accounts and from flows and we will see that if justifying consolidated reserves is sometimes a quite technical challenge, building a correct cash flow statement requires a great deal of rigor at any time of the consolidation process.

The main reason for this is the fact that we must keep in mind that only cash 9 items will be used in the cash flow statement, while cash transactions between group companies cannot appear.

The process of building a consolidated cash flow statement 10

Some basic recommendations can already be issued in order to bring a 11 chance of success on our side while building a cash flow statement.

- Each group company should provide a correct local currency statutory 12 cash flow statement as an input to the consolidation process
- Each consolidation adjustment should be booked, after checking the cash and non cash impacts

- A very strong knowledge of all financial and investments transactions 1 in the group is a necessary guarantee to achieve the work.

Of course, all technical issues such as currency rates changes, changes in 2 consolidation scope, changes in consolidation methods will be highly under control and understood because these technical effects could present some important and unexpected effects.

6.2 A cash flow statement presentation 3

What follows applies to both statutory and consolidated cash flow statement. 4 However, when analyzing more in detail each category, we will highlight some differences brought by consolidated figures.

A cash flow statement consists in three following categories 5

Cash from operating activities	6
Cash from investments and disinvestments activities	
Cash from financial activities	
Net cash variation	

The "Net cash variation" is equal to the total of the three first categories and 7 one difficult point by saying this is the check to be made with the variation of Cash and Cash equivalent accounts as presented in the balance sheet. Both must be equal.

Cash from operating activities 8

This category shows the cash related to the ongoing business and is usually 9 presented under two different methods: the direct method or the indirect method.

The direct method presentation 10

Let's say immediately that this method is supported by few groups only, 11 besides the fact that it is a recommendation of the IFRS rules. The reason for this is the difficulty to capture the input information.

Following this method, the following information is supposed to be provided 12

- Cash received from customers 13

- Cash paid to suppliers 1
- Cash paid to employees
- Financial interests paid/received
- Tax and VAT paid/paid back

and we understand that most accounting systems make it difficult to pick up 2 payments, certainly for customers and suppliers, because there are all mixed up with other financial transactions on different bank accounts.

The indirect method avoids such a difficulty and explains its success.3

The indirect method presentation4

We have two main sub-categories: the cash flow and the working capital.5

The cash flow6

We start by considering the company result which consists in income and 7 expenses, both cash and non cash. The idea is then to evaluate the cash part of that result by reversing all non cash income and expenses.

Without giving the most general and complete definition, cash flow could be 8 defined as follows

- Result of the period 9
- + Non cash expenses
 - o + Depreciations 10
 - o + Use of provisions
 - o + Write-off
 - o + Exchange losses (unrealized)
 - o + Losses on assets disposals
 - o + Deferred taxes (charges)
 - o + ...
- - Non cash income 11
 - o - Reverse of depreciations 12
 - o - Reverse of provisions
 - o - Write-back
 - o - Exchange gains (unrealized)
 - o - Gains on assets disposals
 - o - Deferred taxes (income)
 - o - ...

The total of all these items gives what is called the cash flow.13

The working capital 1

This sub-category contains the net variation of current receivables and 2 current payables.

From a cash point of view, if payables variation is a decrease (negative 3 amount), this variation will appear with a negative sign in the cash flow statement because it represents a cash out.

The opposite must be said for a decrease of receivables, so also a negative 4 amount, with a positive impact in the cash flow statement because it represents cash received from customers.

Cash flow and working capital added together give the "Cash from operating 5 activities".

Cash from investments and disinvestments activities 6

This category represents all acquisitions of intangible, tangible and financial 7 assets on one side and all disposals of these same items on the other side.

Obviously, investments will appear with a negative sign, representing a cash 8 out, and the opposite for all disinvestments.

Nothing special should be added to this if we speak about a statutory cash 9 flow statement, but on the other hand it becomes a problem while considering the consolidated cash flow statement because acquisitions and disposals of consolidated financial investments are eliminated in the balance sheet.

We will have to come back more deeply to that issue later in this chapter. 10

Cash from financial activities 11

This category includes all transactions that are not current. Amongst these 12 transactions, we list hereunder the main items

- Capital increase/decrease (in cash) 13
- New long term loans
- Reimbursement of long term loans
- Grants received
- Dividends paid to shareholders

Net cash variation 14

This is simply the addition of these three cash categories and, as said above, 15 this net amount must be equal to the net variation of Cash and Cash equivalent accounts found in the balance sheet.

6.3 Let's build a statutory cash flow statement ¹

To do so the basic information comes from the flows on balance sheet ² accounts and from some non cash P&L accounts.

Here is the necessary information. ³

	Year 1	Acq.	Disp.	Net var.	Dep.	Gain/disp.	Year 2
Tangible assets							
Acq. Val.	7,000	3,000	(1,200)			200	9,000
Deprec.	(1,000)				(600)		(1,600)
Fin. Invest.	2,000	800	(300)				2,500
Receivables	1,200			400			1,600
Cash	800			(300)			500
Total	10,000						12,000

	Year 1	Increase	Reimb.	Net var.	Prov.	Divid.	Approp.	Profit	Year 2
Capital	3,000	1,000							4,000
Reserves	2,000								2,300
Result	500								400
Provisions	800								1,200
Loans	2,000								1,500
Payables	1,700								2,600
Total	10,000								12,000

For each balance sheet account, we explain in a financial or an accounting ⁶ way what are the changes between opening and closing values.

As you can see, the reason of changes depends on the nature of each account ⁷ and some flows are "cash" and so candidate to impact the cash flow statement while some others are "non cash". In the assets, flows considered as cash are "acquisitions", "disposals" and net variations". In the liabilities, flows considered as cash are "Increase", "Reimbursement", "Net variation" and "Dividends".

The 'Result' flow showing the Year 2 profit is ⁸ ambiguous because it includes cash and non cash amounts as seen in the P&L

	Year 2
Turnover	10,000
Cost of sales	(8,800)
Depreciations	(600)
Provisions	(400)
Gain/disposals	200
Result	400

An important validation between flows and P&L accounts must be done for ¹⁰ "Depreciations", "Provisions" and "Gain on disposals". If the amounts booked on flows and on the corresponding P&L accounts are different, there will be an error in the cash flow statement.