Company P		Year 1	Flows	Year 2
Capital		1,500		2,000
	Increase		500	
Reserves		400	50	450
	Transfer			
Result		100		80
	Transfer		(50)	
	Dividend		(50)	
	Result *Year* 2		80	
Payables/-		1,000		1,470
	Net variation		470	
	Total	3,000	1,000	4,000

Capital is increased by 500 and the Year 1 profit of 100 is partly paid as a dividend for (50) and partly transferred to reserves.

Let's now show the statutory cash flow statement built with the flows mentioned above.

Company P	Year 2
Result	80
Depreciations	0
Gain on disposals	(150)
Cash flow	(70)
Var. Receivables	(300)
Var. Payables	470
Working capital	170
Cash from operating activities	100

We start with the profit of 80 and eliminate non cash amounts in the P&L, gain on disposals in this case.

Considering statutory accounts, net variation of receivables must include also intercompany amounts.

Investments	
Tangible assets	0
Financial invest.	(860)
Disinvestments	
Tangible assets	0
Financial invest.	350
Cash from Inv./Disinv.	(510)

The acquisition of 90% of shares of company B is considered as an investment.
The disposal of 20% of A shares is a disinvestment. It's the cash received that appear here and not the book value disposed.

Capital increase	500
Dividends	(50)
Cash from financial activities	450
Net cash variation	40

The financial part includes a capital increase for 500 and the payment of the dividend for 50.

The net cash variation calculated here can be cross-checked with the net variation found in the balance sheet. It's one of the most important technical validations we can do. If this validation fails, something is certainly wrong in the cash flow statement.

Statutory accounts of company A

Company A		Year 1	Flows	Year 2
Tang. Assets (Acq.)		3,000		3,700
	Acquisition		***1,000***	
	Disposal		*(370)*	
	Gain/disposal		***70***	
Tang. Assets (Dep.)		(800)		(850)
	Depreciation		*(50)*	
Receivables/-		1,300		1,800
	N[illegible]tion		***500***	
Cash		500		350
	Net variation		***(150)***	
	Total	4,000	***1,000***	5,000

This company acquires tangible assets for 1000 and sells some others for 300. These transactions are made with 3rd Parties.

Company A		Year 1	Flows	Year 2
Capital		1,000		1,000
	Increase			
Reserves		600		620
	Transfer		***20***	
Result		50		40
	Transfer		*(20)*	
	Dividend		*(30)*	
	Result Year 2		***40***	
Payables/P		200		300
			100	
Payables/-		2,150		3,040
	Net variation		***890***	
	Total	4,000	*1,000*	5,000

The Year 1 profit of 50 is paid as a dividend for 30 and transferred to reserves for 20. As explained earlier, this dividend of 30 is paid for 24 = 80% * 30 to company P.

There are intercompany payables correctly reconciled with receivables in company P accounts.

Here is the corresponding statutory cash flow statement.

Company A	Year 2
Result	40
Depreciations	50
Gain on disposals	(70)
Cash flow	20
Var. Receivables	(500)
Var. Payables	990
Working capital	490
Cash from operating activities	510

Profit is 40 and there is a depreciation flow of 50 corresponding to depreciations in the P&L for the same amount.

Net variation of payables includes intercompany amounts.

Investments	
Tangible assets	(1,000)
Financial invest.	0
Disinvestments	
Tangible assets	370
Financial invest.	0
Cash from Inv./Disinv.	(630)

There are acquisitions of tangible assets for 1000 and disposals for 370. These transactions are made with 3rd Parties. Notice that this disposal gives a gain of 70 as shown in the cash flow above.

Capital increase	0
Dividends	(30)
Cash from financial activities	(30)
Net cash variation	(150)

No capital increase but only the payment of the dividend for 30. Remember company P receives 24 = 80% * 30.

The net cash variation for (150) is again equal to the net cash variation found in the balance sheet.

<u>Statutory accounts of company B</u>

The most important issue for this company is the fact that it was not consolidated in Year 1. Being acquired on the 1st of January Year 2, all flows mentioned will be taken into account to build the cash flow statement, but all the opening balance sheet amounts have to be ignored. In a consolidation software, these opening amounts would be mentioned on specific flows "Entry in the consolidation scope", considering the fact the opening amounts would have been zero. These flows are considered as non cash.

Company B		Year 1	Flows	Year 2
Tang. Assets (Acq.)		1,000		1,500
	Acquisition		***700***	
	Disposal		*(300)*	
	Gain/disposal		***100***	
Tang. Assets (Dep.)		(600)		(650)
	Depreciation		*(50)*	
Receivables/-		500		800
	Net variation		***300***	
Cash		100		350
	Net variation		***250***	
	Total	1,000	*1,000*	2,000

Company B		Year 1	Flows	Year 2
Capital		200		1,000
	Increase		***800***	
Reserves		70		100
	Transfer		***30***	
Result		30		20
	Transfer		*(30)*	
	Dividend		***0***	
	Result Year 2		***20***	
Payable, -		700		880
	Net variation		***180***	
	Total	1,000	***1,000***	2,000

The disposal of tangible assets has been made for a price of 300, giving a gain on disposal of 100.

As announced, there is a capital increase for 800 which is subscribed for 70% by company P and for 30% by the 3rd Parties. So, we keep the same financial percentage before and after the capital increase. There are no dividends paid.

Here is the corresponding statutory cash flow statement.

Company B	Year 2
Result	20
Depreciations	50
Gain on disposals	(100)
Cash flow	(30)
Var. Receivables	(300)
Var. Payables	180
Working capital	(120)
Cash from operating activities	(150)

We start with the profit of 20 and adjust it with the depreciations and gain on tangible assets disposals.

No intercompany amounts in these net variations.

Investments	
Tangible assets	(700)
Financial invest.	0
Disinvestments	
Tangible assets	300
Financial invest.	0
Cash from Inv./Disinv.	(400)

There are acquisitions of tangible assets for 700 and disposals for a cash received of 300.

Capital increase	800
Dividends	
Cash from financial activities	800
Net cash variation	250

We only have a capital increase and no dividends.

Net cash variation is in line with the one in the balance sheet.

The consolidated cash flow statement

With these three statutory cash flow statements, we are ready to apply the following methodology which consists in adding first these three cash flow statements together. Of course, we will get a technically correct cash flow statement but it will be premature to call it consolidated cash flow statement.

Why?

Because we will have to take into account some of the events which are at this time reflected directly from the statutory accounts but should be adapted to the consolidation requirements.

In the column "Total" hereunder we find the three cash flow statements simply added together.

	P	A	B	Total	J1	J2	J3	J4	Conso
Result	80	40	20	140		(24)		(124)	(8)
Depreciations	0	50	50	100					100
Gain on disposals	(150)	(70)	(100)	(320)				124	(196)
Cash flow	(70)	20	(30)	(80)	0	(24)	0	0	(104)
Var. Receivables	(300)	(500)	(300)	(1,100)	100				(1,000)
Var. Payables	470	990	180	1,640	(100)				1,540
Working capital	170	490	(120)	540	0	0	0	0	540
Cash from operating activities	100	510	(150)	460	0	(24)	0	0	436
Investments									
Tangible assets	0	(1,000)	(700)	(1,700)					(1,700)
Financial invest.	(860)	0	0	(860)			560		(300)
Disinvestments									
Tangible assets	0	370	300	670					670
Financial invest.	350	0	0	350					350
Cash from Inv./Disinv.	(510)	(630)	(400)	(1,540)	0	0	560	0	(980)
Capital increase	**500**	**0**	**800**	**1,300**			(560)		**740**
Dividends	(50)	(30)		**(80)**		**24**			(56)
Cash from financial activities	**450**	(30)	**800**	**1.220**	0	**24**	(560)	**0**	**684**
Net cash variation	**40**	(150)	**250**	**140**	**0**	**0**	**0**	**0**	**140**

The four columns J1 to J4 are adjustments in order to make **it** converge towards the final consolidated cash flow statement. Of course, this requires some consolidation knowledge.

Adiustment J1

If we go back to the statutory accounts of parent company P, we see that receivables have been considered as intercompany amounts included with a total net variation of **600.** In consolidation, we know these intercompany amounts are eliminated as well as the flows attached to them. This means a net variation of only **500.**

The same comment can be done for the payables in company A accounts, which implies to reduce from **990** to **890** their variation. This explains the amount of **100.**

Adiustment 32

In consolidation, we eliminate dividends received from consolidated companies, as **it** has been explained in Part **2** Chapter **8.** This means the company P statutory profit of **80** must be reduced by **24** corresponding to the 80% * **30** of dividends received.

But there is a counterpart to this adjustment. The dividends paid as mentioned on line "Dividends" in the cash flow statement show a payment of **(30)** in A. In fact **(24)** remains in the group by being paid to P. Only **(6)** represents a cash out corresponding to dividends paid to 3^{rd} Parties.

Adiustment J3

We know that the capital of company B has been increased by 500 and that each shareholder has subscribed according to its percentage. Company P brings 560 = 70% * 800 to company B and the 3rd Parties the remaining 240 = 30% * 800. The 560 must be considered as a cash transfer between companies with no effect in the cash flow statement.

The counterpart is the financial investment of (860) that must be adapted to be only (300) corresponding to the cash paid to 3rd Parties for the acquisition of the 70% shares of company B.

Adiustment J4

This last comment concerns the sale of 20% of the shares of company A. In the statutory accounts the 200 book value of these shares has been disposed for a price of 350, giving a gain of 150 = 350 - 200.

In consolidation we know that the value of these 20% is the corresponding part of the equity on that date, that is 324 = 20% * [1000 + 600 +50 – 30], giving a gain of only 26 = 350 – 324. In such situation, we have to book a consolidation adjustment correcting the statutory gain and bringing it to the consolidated gain. The correction amount is 124 = 150 – 26 and the corresponding adjustment is a debit in P&L and a credit in reserves. Consequently, the net profit of parent company P is reduced by 124 and the gain in P&L is now 26 and not 150 any more.

Conclusions

If we are sure we have adjusted the necessary items, then we can state the final column on the right is the consolidated cash flow statement.

A few comments should be given before going further.

- Starting with technically correct statutory cash flow statement, the addition we made maintain a technically valid cash flow statement
- This method requires a good knowledge of all the events that have occurred in Year 2, with a good understanding of their cash influence
- Moreover, the knowledge of what is happening during the consolidation process is also required. All consolidation adjustments modifying the result of a company have an impact in the cash flow statement, most of the time it merely leads to some reclassifications between result and non cash items without modifying the cash flow.

- A special care must be brought to dividends and capital increase to reflect the real cash out or cash in attached to these transactions.

- Without really being aware of the fact, this group has acquired a new company and we didn't worry about a possible goodwill and we will see there is indeed one!

- In the same way, the consolidated equity requires sometimes heavy calculations and difficult justification of evolution between two periods. The cash flow statement doesn't care about minority interests percentages. We 'think 100%".

The example we have just analyzed shows clearly that this method works for a limited number of companies. Adding statutory cash flow statements together is easy, but finding all the necessary adjustments to converge to the consolidated cash flow statement becomes impracticable for groups with a large number of companies, a priori if some are foreign companies. A professional consolidation software becomes a must.

<u>Consolidated accounts – Year 1</u>

We are now going to approach the same problem in a more natural way

- By providing the consolidated accounts of Year 1
- And the same for Year 2
- And by calculating the consolidated flows explaining the evolution of these accounts.

Once these flows are known, we will be able to fill in a first version of a cash flow statement.

<u>Consolidated accounts – Year 1</u>

These accounts are produced with the logic explained in Part 2 Chapter 4 concerning the consolidation method.

Consolidation Year 1	P	A	31	J2	J3	34	35	36	Conso.
Tang. Assets (Acq.)		3,000							3,000
Tang. Assets (Dep.)		(800)							(800)
Fin. Inv./A	800		(800)						0
Receivables	1,800	1,300		(200)					2,900
Cash	400	500							900
Link account (Interco)				200	(200)				0
Link account (Fin. Inv.)			800					(800)	0
Total	3,000	4,000	0	0	(200)	0	0	(800)	6,000

Consolidation Year 1	P	A	J1	J2	33	J4	35	J6	Conso.
Capital	1,500	1,000				(200)	(800)		1,500
Reserves	400	600				(120)	(480)		400
Result	100	50				(10)	(40)		100
Cons. Res. (A)							1,320	(800)	520
Min.. Int. (A)						330			330
Payables	1,000	2,350			(200)				3,150
Total	3,000	4.000	0	0	(200)	0	0	(800)	6,000

Adjustment 31: Elimination of the financial investment via a link account

Adjustments 32 and 13:-Elimination of intercompany amounts via link account

Adiustment J4: Elimination of minority equity of company A and reclassification on minority interests

Adiustment J5: Elimination of group equity of company A and reclassification on consolidated reserves

Adiustment 36: Set link account to zero with counterpart on consolidated reserves of company A

Consolidated accounts - Year 2

This consolidation is a little bit trickier because of the new company B, the dividends and the disposal of shares. Here are the accounts followed by the necessary comments.

Consolidation Year 2	P	A	B	31	32	33	34	35	36	37
Goodwill						90				
Tang. Assets (Acq.)		3,700	1,500							
Tang. Assets (Dep.)		(850)	(650)							
Fin. Inv./A	600						(600)			
Fin. Inv./B	860					(90)		(770)		
Receivables	2,100	1,800	800						(300)	
Cash	440	350	350							
Link account (Interco)									300	(300)
Link account (Fin. Inv.)							600	770		
Total	'4,000	5,000	2,000	0	0	0	0	0	0	(300)

Consolidation Year 2	P	A	B	J1	3 2	J3	34	35	36	37
Capital	2,000	1,000	1,000							
Reserves	450	620	100	24	124					
Result	80	40	20	(24)	(124)					
Cons. Res. (A)										
Cons. Res. (B)										
Min. Int. (A)										
Min. Int. (B)										
Payables	1,470	3,340	880							(300)
Total	4,000	5,000	2,000	0	0	0	0	0	0	(300)

Adiustment J1: Elimination of company A dividend for 24 = 80% * 30

Adiustment **12:** Correction of gain on 20% A shares disposal. For more explanation, see below.

Adiustment **13:** Goodwill concerning company B acquisition is **90** = **300** – 70% * **(200** + 100), the equity considered here is before the capital increase

Adjustment **J4:** Elimination of the A financial investment via a link account

Adiustment **15:** Elimination of the B financial investment via a link account

Adjustments **16** and 37:-Elimination of intercompany amounts via link account

Consolidation Year 2	J8	39	310	311	312	313	Conso.
Goodwill							90
Tang. Assets (Acq.)							5,200
Tang. Assets (Dep.)							(1,500)
Fin. Inv./A							0
Fin. Inv./B							0
Receivables							4,400
Cash							1,140
Link account (Interco)							0
Link account (Fin. Inv.)			(600)			(770)	0
Total	0	0	(600)	0	0	(770)	9,330

Consolidation Year 2	J8	J9	J10	J11	312	313	Conso.
Capital	(400)	(600)		(300)	(700)		2,000
Reserves	(216)	(372)		(30)	(70)		598
Result		(24)		(6)	(14)		(68)
Cons. Res. (A)		996	(600)				396
Cons. Res. (B)					784	(770)	14
Mm. Int. (A)	664						664
Min. Int. (B)				336			336
Payables							5,390
Total	0	0	(600)	0	0	(770)	9,330

Adiustment **18:** Elimination of minority equity of company A and reclassification on minority interests

Adiustment **19:** Elimination of group equity of company A and reclassification on consolidated reserves

Adjustment **110:** Set link account to zero with counterpart on consolidated reserves of company A

Adiustment J11: Elimination of minority equity of company B and reclassification on minority interests

Adiustment **112:** Elimination of group equity of company B and reclassification on consolidated reserves