Consolidation - are you one big happy family?

Consolidation is not a free choice for investors, but some simple shareholder mechanisms may help to achieve it.

Consolidation - Key takeaways

- Consolidation is important to investors - it may drive valuations and demonstrate the true picture of operations
- Consolidation by an investor is not a free choice
- Ability to set the annual budget is generally a red line; without it, it's very unlikely you'll be able to consolidate an investee
- Useful mechanisms can be written into shareholder agreements (i.e. dispute resolution mechanisms or call options)

Companies are increasingly seeking partners in commercial arrangements, both to diversify risk and enhance returns through access to a broader and deeper asset base. Multiple investors may jointly invest in businesses together to share the profits. Franchises, profit share arrangements and joint ventures are all examples commonly seen in the market.

But whether to consolidate or not is not a free choice.

A refresher on the accounting

When a group accounts for a significant interest in an investee, generally it will either:

- consolidate that company, which means grossing up the group's P&L and balance sheet for the investee's revenues, expenses, assets and liabilities (model 1), or
- equity account for the interest in that investee through a single line, being a share of profits and net assets (model 2).

Net profit of the group, in most instances, will not differ regardless of the model used. The holder of the substantial interest will either allocate a share of profit to minority interests (model 1) or simply only account for its own share of profits (model 2). Critically, however, gross revenue and the balance sheet will be significantly different if consolidation is achieved.

For finance teams, this can often lead to directors asking 'Can we, or even must we, consolidate this business?

AASB 10 *Consolidated Financial Statements* sets out extensive guidance on the relevant criteria for consolidation of an investee. In this article we look at some examples of business structures that can often qualify for consolidation and explore a number of the associated issues. But first, let's have a quick recap on why consolidation matters to investors.

pwc

When entering into any arrangement involving other investors or other stakeholders, the ability to consolidate is often a key consideration. Shareholders clearly care. The Harvey Norman press headlines last year on the potential consolidation of franchisees is one such example of public scrutiny of a group's consolidated balance sheet position.

Similarly, investors also care about the ability to consolidate the revenue of an investee within a group's total revenues. McKinsey, in their article 'Grow Fast or Die Slow'[1] also identify revenue growth as having twice as much impact on share prices as improving margins in some circumstances. Consolidation of an investee is one quick way to immediately increase reported group revenue. Other considerations may include bank covenants or remuneration arrangements where EBITDA and other metrics can be varied through consolidation.

Key decisions - who's doing the driving?

AASB 10 requires an investor to be able to control decision making over relevant activities. However, what these activities are is a matter of judgement. The standard does not prescribe any bright line activities. However, in practice, approval or veto over the annual budget or business plan should always be considered first. If an investor does not have unilateral authority to set the annual budget over any objections of others, it's extremely unlikely they'll be able to demonstrate control and the ability to consolidate. Other activities will also likely matter, with control of the budget not automatically proving capacity to control. But, the absence of control over the budget is a red flag that consolidation is not possible.

Dispute resolution - who is Simon and when does he get to say.......?

Take the example of two investors in a company that intend to operate that business jointly. Decision making might be shared or one party might plan to be silent but still have the ability to veto certain decisions, including the annual budget. AASB 10 would require an extended analysis of whether that veto right is protective or not, regardless of relative ownership interest. For an investor in such a business, consolidation would require the capacity to control that company. Joint decision making, or a veto right, inherently would contradict that when it relates to day-to-day operations such as the budget approval.

To demonstrate the ability to control, and therefore to consolidate, investors may then look to the dispute resolution provisions in their shareholder agreement. Giving another investor a veto right may lead to intractable disputes or frustration. In such circumstances, a tie-breaker mechanism would be relevant to assessing control. If a company could structure that tie-breaker to give it a casting vote, after necessary escalation, then capacity to control would be achieved. The other investor may still be satisfied if the escalation process is sufficiently rigorous; for example, in requiring consultation among the investors' chairs and CEOs so that concerns may be appropriately heard. Consequently, including such a tie-breaker in a shareholder agreement is relevant if consolidation is an objective.

Call options over investee shares

Puts and calls may also be used between investors to manage disputes on the operation of an investee. If investors cannot agree on decision making, rather than giving one party a casting vote, an investor may have the right to buy out the other investor (a call option). A call option at a realistic price would give an investor the capacity to control an investee and therefore consolidate the results. Any deadlock or conflict with other investors could be broken by exercising the call and acquiring all of the voting rights. Take the original scenario where both investors must approve the annual budget of an investee. If one investor may buy out the other for fair value if the two parties cannot agree, then that investor has the capacity to control the investee. Consolidation accounting would then be applied.

Critically, the ability to consolidate will also depend on whether the call option is currently exercisable. If the investor can exercise the call immediately in the event of a dispute, consolidation is possible as capacity to control currently exists. If the investor must wait 3 years, for example, then capacity to control will only exist at that point in time. Consolidation would not be possible before then.

---

[1] Grow Fast or Die Slow, McKinsey & Company, *High Tech Insights*, April 2014.

Where there's a call there's a put

While call options might enable consolidation, they often come at a cost. It's easy for an investor to ask for a call in the event of a dispute. However, it's also likely that other investors will ask for a put right over their shares. After all, no one wants to be stuck with an investment if the investors cannot agree on how it should operate. The accounting for puts can be complex but generally requires a liability to be recognised. If an investor consolidates the investee, any put over the minority will be recognised in the consolidated balance sheet. A put and a call at the same fixed strike price may also result in an investor recognising a 100% interest in the investee on the basis that either party is certain to exercise their rights.

Conclusion

Consolidating an investee can significantly change a group's balance sheet and income statement. Given there is no bright line accounting standards test that dictates an investor's capacity to control - and therefore consolidate - an investee, it can be an area of significant judgement and debate. As such, where consolidation is the desired result, finance teams should get involved up front when shareholder agreements are being drafted. By doing this and ensuring mechanisms such as those discussed above are included, they'll be able to provide a clear and consolidated path forward.

Acknowledgement

This article was first published as part of the Chartered Accountants Australia and New Zealand's *Perspectives* series.

For more information on this publication please contact:

John Ratna
Partner
PwC - CA
03 8603 2568
john.ratna@pwc.com

Jonathon Moss
Partner
PwC - CA
02 8266 2847
jonathon.moss@pwc.com

Katelyn Bonato
Director
PwC - CA
03 8603 0868
katelyn.bonato@pwc.com