

1 Consolidated financial statements (Lecture A816 – 13.50 minutes)

Issues relating to consolidated financial statements are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 9 *Consolidated and Separate Financial Statements*, and there is overlap with FRS 102, Section 19 *Business Combinations and Goodwill*.

1.1 General recap of consolidated financial statements

Under Companies Act 2006, a parent is required to prepare consolidated financial statements (or group accounts) if it cannot claim any exemptions from this requirement in company law. The general principle where consolidated financial statements are concerned is that the results of each subsidiary within the group are included in the parent's financial statements and the consolidated financial statements then show the results of the group in line with its economic substance, which is that of a single reporting entity (i.e. as if the group structure does not exist).

It is for this reason that all intra-group transactions and balances are eliminated on consolidation. This includes removing any intra-group profits that are not realised at group level (which would often arise if a parent or subsidiary has acquired inventory from another group member and the selling entity has included a profit margin in the 'sale' and all, or some of that inventory is held at the year end and included in the buying subsidiary's inventory valuation). Only when that inventory is sold to an entity outside of the group can any profit element be recognised.

The requirement to present consolidated financial statements is outlined in FRS 102, paras 9.2 to 9.9B. FRS 102, para 9.9A states that a subsidiary may be excluded from consolidation when its inclusion is not material for the purpose of giving a true and fair view. However, two or more subsidiaries may be excluded **only if they are not material when taken together**.

1.2 What are the issues when it comes to consolidated financial statements?

Excluding auditing requirements, consolidated financial statements often contain incorrect accounting treatments which render them misleading. For example, incorrect consolidation of share capital (the consolidated balance sheet should only recognise the parent's share capital). In addition, pre-acquisition reserves are sometimes incorrectly included in group retained earnings (pre-acquisition reserves are included in the goodwill calculation – it is the parent's share of the *post-acquisition* reserves that are included in group retained earnings).

The consolidated profit and loss account is fairly straightforward to prepare once intra-group transactions have been eliminated. It is simply consolidated on a line-by-line basis up to the profit after tax line. It must then present the profit (or loss) attributable to both the parent and the non-controlling interest at the foot of the consolidated profit and loss account:

Illustrative example – consolidated profit and loss account

	31.12.2022	31.12.2021
	£	£
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>

The consolidated balance sheet is inherently more complex to prepare. Under UK and Ireland GAAP, the consolidated balance sheet must show the ownership split between the parent and the non-controlling interest (although this will not be the case where the subsidiary is wholly owned). FRS 102, para 9.14 requires profit or loss and changes in equity attributable to the owners of the parent and non-controlling interest to be determined on the basis of existing ownership interest. The allocation at the balance sheet date does not reflect the potential exercise or conversions of options or convertible instruments (e.g. convertible loans).

The table below summarises the consolidation method for the consolidated balance sheet:

Area	Consolidation method
Assets	Amalgamate on a line-by-line basis
Liabilities	Amalgamate on a line-by-line basis
Share capital	Parent company only
Reserves	Group reserves comprise: <ul style="list-style-type: none"> • Parent's reserves plus (profit) or minus (loss) • Share of subsidiary's post-acquisition profit or loss
Goodwill	Capitalise and amortise
Non-controlling interest	Their share of the subsidiary's net assets at the balance sheet date

1.3 Goodwill

Firms need to understand that some accountants may be more familiar with the requirements of IFRS® Accounting Standards when it comes to consolidated financial statements (particularly where the preparer is newly qualified or is a trainee studying examinations that examine IFRS Accounting Standards). Under IFRS Accounting Standards, goodwill is **not** amortised, but is instead tested annually for impairment at each reporting date.

Under FRS 102, goodwill is capitalised and amortised over its useful life on a systematic basis. In practice, the amortisation method is usually the straight-line method. There is no option under FRS 102 to assign an indefinite useful life to goodwill and, in some cases, it does not appear that goodwill has been amortised which contravenes the requirement in FRS 102, para 19.23(a).

If management are unable to make a reliable estimate of the useful life of goodwill, FRS 102, para 19.23(a) states that the useful life must not exceed ten years. Keep in mind that this ten-year 'cap' is a maximum (not a minimum). An entity could assign a shorter useful life in the rare instance that management cannot assign a reliable useful economic life to goodwill. What they cannot do in this situation is assign a longer useful life.

Auditors must also obtain sufficient appropriate audit evidence concerning the amortisation period and rate for goodwill (where material). Recalculating goodwill amortisation will often be insufficient and the auditor must ensure they obtain corroborative reasons for the goodwill amortisation rate – especially where this is over a long period (such as 20 years). Firms are often criticised for the lack of audit work that they perform on goodwill (and intangible assets) as the evidence obtained is often weak.

IFRS 3 *Business Combinations* allows an entity to recognise the non-controlling interest share of goodwill at fair value at the date of acquisition. This is often called the 'full goodwill method'. Under FRS 102, this method is not permitted and only the parent's proportionate share of goodwill can be recognised.

4.3.1 Goodwill impairment

Confusion often surrounds the issue of goodwill impairment and this is an area that lends itself to many pitfalls which must be avoided if the consolidated financial statements are to give a true and fair view.

Impairment of goodwill is dealt with in FRS 102, Section 27 *Impairment of Assets*, paras 27.24 to 27.27. FRS 102, para 27.24 recognises that goodwill, on its own, cannot be sold. In addition, it does not create cash flows for an entity which are independent of the cash flows of other assets. This means that the fair value of goodwill cannot be measured directly and hence the fair value of goodwill must be derived from measurement of the cash-generating unit (CGU) of which the goodwill forms part. In other words, goodwill can never be treated as a separate asset for the purpose of impairment testing and must be included as part of an existing (or newly created) CGU.

FRS 102, para 27.25 then goes on to state that, for the purpose of impairment testing, goodwill that has been acquired in a business combination, from the date of acquisition, must be allocated to each of the acquirer's CGU's that are expected to benefit from the synergies of the combination, regardless of whether other assets or liabilities of the acquiree are assigned to those units.

For non-wholly owned subsidiaries, part of the recoverable amount of a CGU is attributable to the non-controlling interest. During the impairment test, FRS 102, para 27.26 requires the carrying amount of that unit to be notionally adjusted before being compared with recoverable amount. This is done by grossing up the carrying amount of goodwill that is allocated to the unit to include the goodwill attributable to the non-controlling interest. It is this notionally adjusted carrying amount which is then included within the CGU to determine if the CGU is impaired.

Example – Notionally adjusted goodwill and impairment loss calculation

Holdco owns 80% of Subco. At the balance sheet date, the carrying amount of Subco's net assets were £880,000 which excludes goodwill of £120,000 (net of amortisation).

During the year, Subco was the subject of adverse publicity due to unorthodox practices which has had a detrimental impact on the business. Subco's individual financial statements are showing a large loss has been incurred at the year end and some large customers have chosen not to deal with the business.

The finance director has calculated recoverable amount of Subco's net assets to be £950,000.

As Subco is not wholly owned, goodwill must be notionally adjusted to take account of the non-controlling interest. The impairment loss is calculated as follows:

	£'000	£'000
Goodwill	120	
Unrecognised NCI (£120k x 20/80)	30	
Notionally adjusted goodwill		150
Net assets		880
Carrying amount		1,030
Recoverable amount		(950)
Impairment loss		80

All £80,000 is allocated to the notionally adjusted goodwill, but as the subsidiary is only 80% owned, only £64,000 is actually booked as the other £16,000 is allocated to the non-controlling interest and will appear in their financial statements.

A common pitfall for groups is to try and impairment test goodwill in isolation, which is incorrect because goodwill does not generate cash flows by itself. Another pitfall to avoid is forgetting to notionally adjust goodwill when the subsidiary is not wholly owned by the parent.

1.4 Acquisitions and disposals

This area of consolidated financial statements is an area in which the preparer must have a sound understanding because the rules changed when FRS 102 was brought in.

Acquisitions may take place over a long period of time and these are often referred to as 'step' acquisitions or 'piecemeal' acquisitions. Such acquisitions arise when a parent acquires additional ownership interest in an investee, thus creating a reduction in non-controlling interest. Some investments can, in fact, become a subsidiary when additional acquisitions result in the parent acquiring more than 50% ownership interest (unless there is clear evidence to suggest control has not been obtained).

Where a parent already has control over a subsidiary (i.e. when it already owns more than 50%) and it acquires further ownership interest, non-controlling interest will reduce.

Under FRS 102, the net assets of the subsidiary are **not** revalued and no additional goodwill is recognised because FRS 102, para 9.19D would regard this as a transaction among equity holders in their capacity as equity holders.

Example – Further investment in a subsidiary

On 1 June 2021, Topco Ltd acquired 70% of the net assets in Subco Ltd for a consideration of £500,000 in cash. On the date of acquisition, the fair value exercise revealed the net assets of Subco to be £380,000 and (for simplicity) this value is also equivalent to book values (this would rarely be the case in practice). On 1 June 2022, Topco agreed to invest an additional £75,000 in Subco in exchange for a further 10% of the net assets and on this date Subco's net assets had a book value of £435,000 and a fair value of £485,000. The group's accounting reference date is 31 May.

Accounting for the subsidiary at the date of acquisition (1 June 2021)

At the date of acquisition, Topco has acquired control of Subco because it has acquired an ownership interest of 70% of the net assets. Consequently, the identifiable net assets and liabilities of Subco are consolidated at their fair value of £380,000. Positive goodwill arises amounting to £234,000 as follows:

Cost of investment	500,000
Less net assets acquired	
(70% x £380,000)	(266,000)
Positive goodwill	<u>234,000</u>

At the date of acquisition, non-controlling interest (NCI) is £114,000 (or 30% x £380,000).

Year end 31 May 2022

The increase in Subco's net assets amounts to £55,000 (£435,000 less £380,000) which has arisen due to the profit yielded by Subco during the year to 31 May 2022. This profit is split £38,500 to Topco (being 70% x £55,000) and £16,500 (30% x £55,000) to the NCI. NCI share is now £130,500 (£114,000 brought forward plus £16,500).

Further acquisition on 1 June 2022

On 1 June 2022, Topco acquired a further 10% of Subco which means that the NCI's share of Subco's net assets falls from 30% to 20%.

NCI's share in Subco decreases by £43,500 ((30% - 10%) x £435,000) and their share will now equal £87,000 (£130,500 less £43,500) or 20% x £435,000.

This further acquisition is accounted for as a transaction among equity holders and the consequential change in NCI is accounted for under FRS 102, para 22.19. This means the NCI is adjusted to reflect the parent's additional ownership interest in the subsidiary. Any difference between the value of the NCI adjustment and the consideration paid to acquire the additional 10% is recognised in equity and attributed to the equity holders of the parent as follows:

	£
Dr Non-controlling interest	43,500
Dr Equity attributable to the parent	31,500
Cr Cash at bank	(75,000)

4.4.1 Disposals

When a parent disposes of ownership interest in a subsidiary such that control is lost (hence ownership interest reduces to 50% or less), a gain or loss is recognised in the consolidated profit and loss account, calculated as the difference between:

- (a) the disposal proceeds (or the event which resulted in the parent losing control); and
- (b) the proportion of the carrying amount of the subsidiary's net assets, including any related goodwill, disposed of (or lost) at the date of disposal, or the date on which control is lost.

A partial disposal may arise, but the parent may still retain a controlling interest (i.e. the parent may own more than 50% of the subsidiary following the disposal). In such situations, the disposal is accounted for as a transaction among equity holders in their capacity as equity holders. In other words, the carrying amount of the NCI is increased to reflect the parent's reduced ownership interest. Any difference between the consideration received by the investor and the amount of adjustment to NCI is recognised directly in equity.

Example – Disposal where parent retains control

On 31 March 2022, Topco Ltd disposes of a 20% ownership interest in Subco Ltd for £300,000 which reduced Topco's holding from 80% to 60%. On this date, the carrying amount of the identifiable net assets in Subco was £500,000 and the carrying amount of goodwill on acquisition at the date of disposal was £30,000.

Under FRS 102, no gain or loss is recognised on the disposal as the transaction is treated as one between equity holders in their capacity as equity holders because Topco still retains control of Subco.

The NCI will increase from 20% to 40% and hence the NCI's share of Subco's net assets will increase from £100,000 (£500,000 x 20%) to £200,000 (£500,000 x 40%), i.e. by £100,000. No goodwill is attributable to the NCI.

As Topco has retained control following the partial disposal, FRS 102, para 22.19 will apply. The carrying amount of the NCI is adjusted to reflect the change in Topco's ownership of Subco's net assets. The difference between the NCI adjustment and the fair value of the consideration received is recognised in equity and attributed to the equity holders of Topco, i.e.:

	£
Dr Cash at bank	300,000
Cr Non-controlling interest	(100,000)
Cr Equity attributable to Topco	(200,000)

1.5 Disclosures

There are many disclosures that need to be made in consolidated financial statements which are covered as follows:

FRS 102, para 9.23

FRS 102, para 9.23 requires the following to be disclosed in the consolidated statements:

- (a) *the fact that the statements are consolidated financial statements;* FRS 102, para 9.23
- (b) *the basis for concluding that control exists when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;*
- (c) *any difference in the reporting date of the financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements;*
- (d) *the nature and extent of any significant restrictions (eg resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans;*

- (e) *the name of any subsidiary excluded from consolidation and the reason for exclusion; and*
- (f) *the nature and extent of its interest in unconsolidated special purpose entities, and the risks associated with those interests.*

Company law disclosures

The Large and Medium-sized (Companies and Groups) (Accounts and Reports) Regulations 2008 (SI 2008/410), Sch 6 require the following to be disclosed:

(2) *There must be stated—*

- (a) *the name of the undertaking acquired or, where a group was acquired, the name of the parent undertaking of that group, and*
- (b) *whether the acquisition has been accounted for by the acquisition or the merger method of accounting;*

SI 2008/410,
Sch 6, para 13

and in relation to an acquisition which significantly affects the figures shown in the group accounts, the following further information must be given:

- (3) *The composition and fair value of the consideration for the acquisition given by the parent company and its subsidiary undertakings must be stated.*
- (4) *Where the acquisition method of accounting has been adopted, the book values immediately prior to the acquisition, and the fair values at the date of acquisition, of each class of assets and liabilities of the undertaking or group acquired must be stated in tabular form, including a statement of the amount of any goodwill or negative consolidation difference arising on the acquisition, together with an explanation of any significant adjustments made.*
- (5) *In ascertaining for the purposes of sub-paragraph (4) the profit or loss of a group, the book values and fair values of assets and liabilities of a group or the amount of the assets and liabilities of a group, the set-offs and other adjustments required by this Schedule in the case of group accounts must be made.*

Goodwill

There must also be stated in a note to the accounts the cumulative amount of goodwill resulting from acquisitions in that and earlier financial years which has been written off otherwise than in the consolidated profit and loss account for that or any earlier financial year.

SI 2008/410,
Sch 6, para 14

That figure must be shown net of any goodwill attributable to subsidiary undertakings or businesses disposed of prior to the balance sheet date.

Disposals

Where during the financial year there has been a disposal of an undertaking or group which significantly affects the figures shown in the group accounts, there must be stated in a note to the accounts—

*SI 2008/410,
Sch 6, para 15*

- (a) the name of the undertaking or, as the case may be, of the parent undertaking of that group, and*
- (b) the extent to which the profit or loss in the group accounts is attributable to profit or loss of that undertaking or group.*

The Regulations do not require the disclosures by paras 13, 14 and 15 if the subsidiary:

- is established under the law of a country outside the UK; or
- carries on its business outside the UK.

Where the directors deem the information required by paras 13, 14 and 15 to be seriously prejudicial to the business of that undertaking, or the business of the parent and/or group, and the Secretary of State is in agreement, that information should not be disclosed.

In-year acquisition accounted for by the merger method

Where an acquisition has taken place in the financial year and the merger method of accounting has been adopted, the notes to the accounts must also disclose—

*SI 2008/410,
Sch 6, para 16A*

- (a) the address of the registered office of the undertaking acquired (whether in or outside the United Kingdom),*
- (b) the name of the party referred to in paragraph 10(a),*
- (c) the address of the registered office of that party (whether in or outside the United Kingdom), and*
- (d) the information referred to in paragraph 11(6).*

Exempt groups

Where consolidated financial statements are not prepared, para 10(1) of Sch 4 *Information on related undertakings required whether preparing Companies Act or IAS accounts* requires disclosure as to the reasons why the company is not required to prepare group accounts.

Excluded subsidiaries

Where a subsidiary has been excluded from consolidated financial statements, para 16 of Sch 4 to the Regulations requires the reason for its exclusion to be disclosed. In addition, paragraph 2 requires the following to be disclosed:

- the aggregate amount of its capital and reserves as at the end of its relevant financial year; and
- its profit or loss for that year.

This information is not required if:

- the investment is accounted for using the equity method of accounting; or
- the subsidiary is not required to deliver a copy of its balance sheet and does not publish that balance sheet in the UK or elsewhere and the holding of the group is less than 50% of the nominal value of the shares in the undertaking; or
- the information is immaterial; or
- the company is exempt by virtue of CA06, ss 400 or 401 from the requirement to prepare consolidated financial statements.

FRS 102, Section 19: Business combinations effecting during the period

For business combinations that have taken place during the reporting period, FRS 102, para 19.25 requires the following to be disclosed:

(a) *the names and descriptions of the combining entities or businesses;*

(b) *the acquisition date;*

(c) *the percentage of voting equity instruments acquired;*

FRS 102, para
19.25

(d) *the cost of the combination and a description of the components of that cost (such as cash, equity instruments and debt instruments);*

(e) *the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, including goodwill;*

(f) *[Deleted]*

(fA) *a qualitative description of the nature of **intangible assets** included in goodwill;*

(g) *the useful life of goodwill, and if this cannot be reliably measured, supporting reasons for the period chosen; and*

(h) *the periods in which the excess recognised in accordance with paragraph 19.24 will be recognised in profit or loss.*

Paragraph 19.25A also requires the following:

The acquirer shall disclose, separately for each material business combination that occurred during the reporting period, the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period. The disclosure may be provided in aggregate for business combinations that occurred during the reporting period which, individually, are not material.

FRS 102, para
19.25A

FRS 102, Section 19: All business combinations

FRS 102, para 19.26 states:

*An acquirer shall disclose a reconciliation of the **carrying amount** of goodwill at the beginning and end of the reporting period, showing separately:*

FRS 102, para
19.26

- (a) changes arising from new business combinations;*
- (b) amortisation;*
- (c) impairment losses;*
- (d) disposals of previously acquired businesses; and*
- (e) other changes.*

This reconciliation need not be presented for prior periods.

Finally, FRS 102, para 19.26A states:

An acquirer shall disclose a reconciliation of the carrying amount of the excess recognised in accordance with paragraph 19.24 at the beginning and end of the reporting period, showing separately:

FRS 102, para
19.26A

- (a) changes arising from new business combinations;*
- (b) amounts recognised in profit or loss in accordance with paragraph 19.24(c);*
- (c) disposals of previously acquired businesses; and*
- (d) other changes.*

This reconciliation need not be presented for prior periods.