Think Ahead ACCA

Technical factsheet
Consolidated financial statements

Contents

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INTRODUCTION

This factsheet provides an overview and refresher, including practical examples and legislative references when consolidations are undertaken under FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland.*

LEGISLATIVE REQUIREMENTS

FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

FRS 102 deals with business combinations and goodwill in Section 19 *Business Combinations and Goodwill*. However, there is a close interaction with other sections of FRS 102 where consolidated financial statements are concerned, which are shown in the following table:

Relevant section of FRS 102	Why it is relevant
Appendix to Section 2 *Concepts and Pervasive Principles*	The Appendix to Section 2 provides guidance on arriving at fair values that are used in business combinations
Section 11 *Basic Financial Instruments* Section 12 *Other Financial Instruments Issues*	These sections cover the accounting treatment of investments in entities that qualify as financial assets
Section 14 *Investments in Associates*	This section deals with the accounting treatments of investments in associates, including outlining the equity method of accounting that is relevant to the consolidated financial statements
Section 15 *Investments in Joint Ventures*	This includes the general principles relating to joint ventures and overlaps with the equity method of accounting noted above in Section 14
Section 27, *Impairment of Assets*	This deals with the carrying value of financial assets that should not be held at a value exceeding recoverable amount, at parent level (ie investments in group entities) and at group level (ie goodwill on consolidation)
Section 30, *Foreign Currency Translation*	This section deals with the translation of investments in foreign operations

The above sections act as building blocks where the consolidated financial statements are concerned. They are supported by other sections of FRS 102 that are relevant to the consolidated financial statements, including:

- Section 7 *Statement of Cash Flows*
- Section 10 *Accounting Policies, Estimates and Errors*
- Section 29 *Income Tax*
- Section 33 *Related Party Disclosures*
- Section 35 *Transition to this FRS*

Taken together, this should ensure that the consolidated financial statements are prepared correctly and the disclosures are complete.

Why consolidated financial statements are prepared

It is important at the outset to appreciate the reasons why consolidated financial statements (often referred to as group accounts) are prepared in the first place.

The objective of consolidated financial statements is to present the results of the group in line with its economic substance, which is that of a single reporting entity.

Financial statements, including consolidated financial statements, must report the **substance** of transactions and arrangements. UK GAAP does not specifically define 'substance over form' but the concept has been enshrined in accounting standards for decades.

When an entity correctly applies substance over form, the financial statements will portray the commercial reality of a transaction or arrangement rather than its legal form. Essentially, the economic substance reports the 'commercial reality' of a transaction.

For the purposes of consolidated financial statements, the economic substance is that the group structure does not exist and hence the consolidated financial statements present the results of the group as a single reporting entity. For this reason, an elimination process must be followed when the consolidation is being carried out, which involves eliminating intra-group transactions and balances.

Requirement to prepare

Section 399(2) of the Companies Act 2006 states that if, at the end of the year, a company is a parent company, the directors must prepare group accounts for the year as well as individual accounts unless the company is exempt from the requirement.

The Companies Act 2006 provides an exemption from preparing consolidated financial statements for a small group. Medium-sized and large groups are required to prepare consolidated financial statements. It is therefore essential to determine the size of a parent and group correctly.

A group is classified as small, medium-sized or large according to the size thresholds outlined in the Companies Act 2006. The thresholds relevant to groups according to Companies Act 2006 are as follows:

Size of group	Turnover	Balance sheet total	Number of employees
Small	Not more than £10.2m net or £12.2m gross[1]	Not more than £5.1m net or £6.1m gross	Not more than 50
Medium-sized	Not more than £36m net or £43.2m gross[2]	Not more than £18m or £21.6m gross	Not more than 250
Large	More than £36m net or £43.2m gross	More than £18m net or £21.6m gross	More than 250

The group must meet two of the above three criteria for two consecutive years in order to be classed as small, medium-sized or large.

With regards to the above table, there are some important points to note:

a) The term 'balance sheet total' is fixed assets *plus* current assets per s382(5), Companies Act 2006. It is important not to use net assets because this figure is derived after the deduction of the group's liabilities. The term 'balance sheet total' is also referred to as 'gross assets'.

b) The average number of employees is the average number employed by the group during the year. It is not the actual number of employees in the group's employment at the reporting date. S382(6), Companies Act 2006 sets out the required calculation as follows (s382(6) refers to 'company' rather than 'group' but as individual companies will be included in the consolidation, this requirement is relevant):

[1] S383(4), Companies Act 2006
[2] S466(4), Companies Act 2006

(i) find for each month in the financial year the number of persons employed under contracts of service by the company in that month (whether throughout the month or not)
(ii) add together the monthly totals
(iii) divide by the number of months in the financial year.

c) References to 'gross' in the above table mean the effects of intra-group trading have **not** been eliminated, whereas references to 'net' mean they have.

d) A subsidiary whose financial statements are consolidated with those of a parent cannot qualify as a micro-entity. Charities are also unable to qualify as micro-entities.

Example: determining the size of a group

Extracts from the accounting records of Sunnie Group Ltd for its first year of trading show the following information:

- Gross turnover £14m
- Net turnover £10m
- Total assets (gross) £5.7m
- Total assets (net) £5.5m
- Number of employees 61

Based on size criteria, the group would qualify as small on the grounds that net turnover is below £10.2m and total assets are below £6.1m. The group does, however, exceed the employee headcount criterion but two out of the three qualifying criteria have been met, hence the group can be classed as small and claim exemption from preparing consolidated financial statements.

Consider that if turnover was £17.1m gross and £14.3m net, the group would not qualify as small because it breaches two out of the three size criteria (on both turnover and employee headcount). Hence, in this case the group would be classed as medium-sized and consolidated financial statements would be required.

Individual companies that are parent companies

Individual parent companies must meet the size criteria shown above in order to qualify as micro, small or medium-sized on an individual company basis. A parent company will only qualify as a small company in relation to a financial year if the group headed by it qualifies as a small group.

Example: Small company that is a parent

Churchill Ltd owns a 100% interest in Revere Ltd and would like to prepare its financial statements under FRS 102, including applying the presentation and disclosure requirements of Section 1A *Small Entities*.

Section 383(1) Companies Act 2006 states that a parent company can only qualify as a small company in a financial year if the group headed up by it qualifies as a small group.

If Churchill Ltd would qualify as a small company but Revere Ltd qualifies as a medium-sized company, Churchill would only be entitled to the exemptions available to a medium-sized company when preparing its individual financial statements.

In terms of the group accounts, it would only be necessary for Churchill to consider the size of the group it heads up. This would be the case even if the group is small, hence not preparing group accounts, on the basis that it may be part of a larger group.

Company law exemptions

At the outset, it is worth noting that small groups are exempt from the requirement to prepare consolidated financial statements. However, if a small group voluntarily prepares consolidated financial statements, FRS 102, para 1A.22 will apply, which states:

If a small entity that is a parent voluntarily chooses to prepare consolidated financial statements it:

a) *shall apply the consolidation procedures set out in Section 9 Consolidated and Separate Financial Statements;*

b) *is encouraged to provide the disclosures set out in paragraph 9.23*[3]*;*

c) *shall comply as far as practicable with the requirements of Section 1A as if it were a single entity (Schedule 6 of the Small Companies Regulations, paragraph 1(1))*[4]*; and*

d) *shall provide any disclosures required by Schedule 6 of the Small Companies Regulations*[5]*.*[6]

The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) extended the scope requirement to include a company that is a public limited company (plc) provided that it would otherwise qualify as small and the company is not a traded company. A company is a traded company if it has securities traded on a regulated market such as the London Stock Exchange. It should be noted that the Alternative Investment Market (AIM) is not currently defined as a regulated market for this purpose.

Amendments to company law following Brexit

In December 2020, the Financial Reporting Council (FRC) issued *Amendments to UK and Republic of Ireland accounting standards – UK exit from the European Union*. These amendments reflected changes in company law following the end of the transition period. The majority of the amendments simply changed references to 'EU' to 'UK' and 'EU-adopted IFRS' to 'UK-adopted IFRS' or 'adopted IFRS'.

The amendments took mandatory effect for accounting periods commencing on or after 1 January 2021. Early application was permissible in some circumstances to provide UK entities with the option to use IAS that are adopted for use in the UK after 31 December 2020, in addition to IFRS Standards that had been adopted in the EU as at this date. The amendments document confirms that this is consistent with the transitional arrangements provided in UK company law for entities preparing 'IAS accounts'.

S400, Companies Act 2006 exemption

Section 400, Companies Act 2006 provides exemption from preparing consolidated financial statements for a company that is included in the group accounts of a larger group. The company will be exempt if it is itself a subsidiary undertaking and its immediate parent is established under the law of any part of the UK, provided the following conditions in s400(1)(a) to (c) are met:

a) The company is a wholly owned subsidiary of that parent undertaking.

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[3] Irish small entities are required to provide certain of these disclosures
[4] Irish small entities shall refer to Schedule 4A to the Companies Act 2014, paragraph 2(1)
[5] Irish small entities shall refer to Schedule 4A to, and sections 294, 296, 307 to 309, 317, 320, 321 and 323 of, the Companies Act 2014
[6] FRS 102, para 1A.22

b) The parent undertaking holds 90% or more of the allotted shares in the company and the remaining shareholders have approved the exemption.

c) The parent undertaking holds more than 50% (but less than 90%) of the allotted shares in the subsidiary and notice requesting the preparation of consolidated financial statements has not been served on the company by shareholders who hold in aggregate at least 5% of the allotted shares in the company. The notice must be served at least six months prior to the end of the financial year to which it relates.

In (b) and (c) above, shares held by a wholly owned subsidiary of the parent undertaking, or held on behalf of the parent undertaking or a wholly owned subsidiary, must be attributed to the parent. In addition, the exemption does not apply to a company that is a traded company.

Shares that are held by directors of a company for the purpose of complying with any share qualification requirement must be disregarded in determining whether the company is a wholly owned subsidiary for the purposes of s400.

S400(2) Companies Act 2006 exemptions

Once the subsidiary meets the above conditions in s400, there are further conditions that must be met under s400(2) as follows:

Exemption is conditional upon compliance with all of the following conditions –

(a) the company must be included in consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking established under the law of any part of the United Kingdom;

(b) those accounts must be drawn up and audited, and that parent undertaking's annual report must be drawn up –

(i) if the undertaking is a company, in accordance with the requirements of this Part of this Act, or, if the undertaking is not a company, the legal requirements which apply to the drawing up of consolidated accounts for that undertaking, or
(ii) in accordance with UK-adopted international accounting standards;

(c) the company must disclose in the notes to its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;

(d) the company must state in its individual accounts the name of the parent undertaking that draws up the group accounts referred to above and –

(i) the address of the undertaking's registered office, or
(ii) if it is unincorporated, the address of its principal place of business;

(e) the company must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question, copies of –

(i) those group accounts, and
(ii) the parent undertaking's annual report,
together with the auditor's report on them;

(f) *any requirement of Part 35 of this Act as to the delivery to the registrar of a certified translation into English must be met in relation to any document comprised in the accounts and reports delivered in accordance with paragraph (e).* [7]

The s400 exemption will only apply when the UK parent is either wholly owned, or majority-owned (ie more than 50% of the allotted shares) by the immediate parent as per FRS 102, para 9.3(bA).

Important point
Note that for financial years commencing on or after 1 January 2021, the parent exemption under s400, Companies Act 2006 for a UK intermediate parent company with an EEA parent no longer applies. However, the s401, Companies Act 2006 exemption will be available where the EEA parent produces consolidated financial statements under EU-adopted IFRS Standards, which are equivalent to those required by UK company law.

If the EEA parent does not produce consolidated financial statements that meet the equivalence test, and nobody further up the group does, the UK intermediate parent will need to produce consolidated financial statements at UK sub-group level.

S401, Companies Act 2006 exemption

As noted in 1.6 above, for UK intermediate parent companies whose EEA parent produces consolidated financial statements that are considered to meet the UK equivalence test, s401 Companies Act 2006 provides an exemption for the UK intermediate parent from producing consolidated financial statements. S401, Companies Act 2006 states:

(1) *A company is exempt from the requirement to prepare group accounts if itself is a subsidiary undertaking and its parent undertaking is not established under the law of any part of the United Kingdom, in the following cases –*

(a) *where the company is a wholly-owned subsidiary of that parent undertaking;*

(b) *where that parent undertaking holds 90% or more of the allotted shares in the company and the remaining shareholders have approved the exemption; or*

(c) *where the parent undertaking holds more than 50% (but less than 90%) of the allotted shares in the company and notice requesting the preparation of group accounts has not been served on the company by the shareholders holding in aggregate at least 5% of the allotted shares in the company.*

Such notice must be served at least six months before the end of the financial year to which it relates.

(2) *Exemption is conditional upon compliance with all of the following conditions –*

(a) *the company and all of its subsidiary undertakings must be included in the consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking;*

(b) *those accounts and, where appropriate, the group's annual report, must be drawn up –*

[7] S400(2), Companies Act 2006

(i) ……. [8]

(ii) *in a manner equivalent to consolidated accounts and consolidated reports drawn up in accordance with the requirements of this Part of this Act,*

(iii) *in accordance with UK-adopted international accounting standards, or*

(iv) *in accordance with accounting standards which are equivalent to such international accounting standards, as determined pursuant to Commission Regulation (EC) No. 1569/2007 of 21 December 2007 establishing a mechanism for the determination of equivalence of accounting standards apply by third country issuers of securities pursuant to Directives 2003/71/EC of the European Parliament and of the Council;*

(c) the group accounts must be audited by one or more persons authorised to audit accounts under the law under which the parent undertaking which draws them up is established;

(d) the company must disclose in its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;

(e) the company must state in its individual accounts the name of the parent undertaking which draws up the group accounts referred to above and –

(i) *the address of the undertaking's registered office (whether in or outside the United Kingdom), or;*

(ii) *if it is unincorporated, the address of its principal place of business;*

(f) the company must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question, copies of –

(i) *the group accounts, and*

(ii) *where appropriate, the consolidated annual report,*
together with the auditor's report on them;

(g) any requirement of Part 35 of this Act as to the delivery to the registrar of a certified translation into English must be met in relation to any document comprised in the accounts and reports delivered in accordance with paragraph (f).

(3) For the purposes of subsection (1)(b) and (c), shares held by a wholly-owned subsidiary of the parent undertaking, or held on behalf of the parent undertaking or a wholly-owned subsidiary, are attributed to the parent undertaking.

(4) The exemption does not apply to a company which is a traded company.

(5) Shares held by directors of a company for the purpose of complying with any share qualification requirement shall be disregarded in determining for the purpose of this section whether the company is a wholly-owned subsidiary. [9]

FRS 102, para 9.3(dA) was included by virtue of the amendments brought about by The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980). The revisions to the act distinguish between a UK parent where 90%, or more, of its allotted shares

[8] S401 (2) (b) omitted (31.12.20 with effect in relation to financial years beginning on or after IP completion day) by virtue of The Accounts and Reports (Amendment) (EU Exit) Regulations 2019 (SI 2019/145), regs. 12(b), 2, Sch 2, para 10(c)(i) (with reg 7(2)) (as amended by SI 2020/523, regs 1(2), 10, 11); 2020 c 1, sch 5 para 1(1).

[9] S401, Companies Act 2006 *Exemption for company included in non-UK group accounts of larger group*

are owned by an immediate parent and one where the immediate parent holds more than 50%, but less than 90%, of the allotted shares.

If the immediate parent owns 90% or more of the UK parent, the remaining shareholders must all approve the exemption. If the immediate parent owns more than 50% but less than 90%, the exemption will not be available if minority shareholders who hold 5% of the total allotted shares have requested consolidated financial statements be prepared. The minority shareholders must serve this notice no later than six months prior to the end of the financial year to which it relates.

S402, Companies Act 2006 exemption

Companies Act 2006, s402 *Exemption if no subsidiary undertakings need be included in the consolidation* states that a parent company is exempt from the requirement to prepare group accounts if, under s405, all of its subsidiary undertakings could be excluded from consolidation in Companies Act group accounts.

Under s405 *Companies Act group accounts: subsidiary undertakings included in the consolidation*, all subsidiary undertakings must be included in the consolidation, except for as follows:

- Its inclusion is not material for the purposes of giving a true and fair view (but two or more undertakings may be excluded only if they are not material taken together).
- Severe long-term restrictions substantially hinder the exercise of the rights of the parent company over the assets or management of that undertaking.
- Extremely rare circumstances mean that the information necessary for the preparation of consolidated financial statements cannot be obtained without disproportionate expense or undue delay.
- The interest of the parent company is held exclusively with a view to resale.

References to the rights of the parent company and the interest of the parent company are, respectively, to the rights and interests held by or attributed to the company for the purpose of the definition of 'parent undertaking' (see s1162, Companies Act 2006) in the absence of which it would not be a parent company.

The final two bullet points above are similar to the wording in FRS 102, para 9.9. However, FRS 102, para 9.9 expands the final bullet point by requiring that the subsidiary has not previously been consolidated in the consolidated financial statements prepared in accordance with FRS 102.

Exemptions from preparing group accounts available under FRS 102

FRS 102, para 9.3 sets out various exemptions from preparing consolidated financial statements as follows:

A parent is exempt from the requirement to prepare consolidated financial statements on any one of the following grounds:

For an entity reporting under the Act, when its immediate parent is established under the law of any part of the UK[10] *or for an entity reporting under the Companies Act 2014, when its immediate parent is established under the law of an EEA State*[11]*:*

(a) *The parent is a wholly-owned subsidiary. Exemption is conditional on compliance with certain further conditions set out in company law.*

[10] Section 400 of the Act
[11] Section 299 of the Companies Act 2014

(b) *The immediate parent holds 90% or more of the allotted shares in the entity and the remaining shareholders have approved the exemption. Exemption is conditional on compliance with certain further conditions set out in company law.*

(bA) *The immediate parent holds more than 50% (but less than 90%) of the allotted shares in the entity, and notice requesting the preparation of consolidated financial statements has not been served on the entity by shareholders holding in aggregate at least 5% of the allotted shares in the entity. Exemption is conditional on compliance with certain further conditions set out in company law.*

For an entity reporting under the Act, when its parent is not established under the law of any part of the UK[12] *or for an entity reporting under the Companies Act 2014, when its parent is not established under the law of an EEA State*[13]*:*

(c) *The parent is a wholly-owned subsidiary. Exemption is conditional on compliance with certain further conditions set out in company law.*

(d) *The parent holds 90% or more of the allotted shares in the entity and the remaining shareholders have approved the exemption. Exemption is conditional on compliance with certain further conditions set out in company law.*

(dA) *The parent holds more than 50% (but less than 90%) of the allotted shares in the entity, and notice requesting the preparation of consolidated financial statements has not been served on the entity by shareholders holding in aggregate at least 5% of the allotted shares in the entity. Exemption is conditional on compliance with certain further conditions set out in company law.*

Other situations

(e) *The parent, and the group headed by it, qualify as small*[14] *and the parent and the group are considered eligible for the exemption*[15]*.*

(f) *All of the parent's subsidiaries are required to be excluded from consolidation by paragraph 9.9*[16]*.*

(g) *For a parent not reporting under the Act, if its statutory framework does not require the preparation of consolidated financial statements.*

In sub-paragraphs (a) to (dA), for an entity reporting under the Act, the parent is not exempt if any of its transferable securities are admitted to trading on a UK regulated market and for an entity reporting under the Companies Act 2014, the parent is not exempt if any of its transferable securities are admitted to trading on a regulated market of any EEA State within the meaning of Directive 2004/39/EC.' [17]

This particular paragraph was amended in July 2015 due to The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) by inserting paragraph 9.3(bA)

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12 Section 401 of the Act

13 Section 300 of the Companies Act 2014

14 UK entities shall refer to section 383 of the Act. Irish entities shall refer to section 280B of the Companies Act 2014

15 UK entities shall refer to sections 384 and 399(2A) of the Act. Irish entities shall refer to sections 280B and 293(1A) of the Companies Act 2014

16 UK entities shall refer to section 402 of the Act. Irish entities shall refer to section 301 of the Companies Act 2014

17 FRS 102, para 9.3

(see above). Prior to the amendments, Companies Act 2006 did not distinguish between a majority-owned UK parent where more than 90% of the allotted shares are owned by the immediate parent and one where more than 50% but less than 90%, are so owned. Prior to the July 2015 amendments, the exemption was not available if minority shareholders, holding in total more than 50% of the remaining allotted shares, or 5% of the total allotted shares, requested the parent to prepare consolidated financial statements. This request (ie the notice) had to be served no later than six months after the end of the previous financial year.

Prior to the July 2015 revisions to Companies Act 2006, if the immediate parent owned 90% or more of the allotted shares, unanimous agreement by the remaining 10% was not required. Following the July 2015 revisions to Companies Act 2006, unanimous agreement is required.

If the immediate parent owns more than 50% but less than 90% of the allotted shares, the exemption is not available when the minority shareholders holding in aggregate 5% of the total allotted shares have requested consolidated financial statements be prepared. The notice must be received by the parent from the minority shareholders no later than six months **before** the end of the financial year to which it relates (s400(1)(c), Companies Act 2006).

Important point
There are several exemptions from preparing consolidated financial statements available in company law, and groups may be able to take advantage of them. However, care must be taken because groups can be complex in terms of identifying parents and intermediate parents as well as subsidiaries because it is easy to fall into one of the many pitfalls where the exemptions are concerned (especially given some of the complex changes to company law as a result of Brexit). In complex cases, it is always advisable to recheck the interactions of the exemptions to ensure correct application of company law and/or UK GAAP.

Ineligible groups

The term 'ineligible' means that the group is unable to take any exemptions that apply to small or medium-sized companies and groups.

In practice, the effect of being an ineligible group means that exemptions for small and medium-sized companies are unavailable where a group member has shares admitted to trading on a UK regulated market (or, for periods commencing before 1 January 2021, a regulated market rather than a UK regulated market).

Section 384 *Companies excluded from the small companies regime*, Companies Act 2006 states that a company cannot qualify as small if it was, any time within the financial year to which the accounts relate:

(a) *a public company,*

(b) *a company that –*

- *(i)* *is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or*
- *(ii)* *carries on insurance market activity, or*
- *(iii)* *is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 (interpretation of Part 1), or*

(c) *a member of an ineligible group.*

Where an ineligible group is concerned (ie in (c) above), the test of whether a small company is a member of an ineligible group is in a two-way direction (ie up and down). It will therefore be necessary to look at the largest group of which the company is a member and consider whether it is ineligible.

This is not the same test as the size thresholds test described in the introductory section of this factsheet. In the size tests above, it is only necessary to consider the size of the company and, where relevant, any subsidiaries. For ineligible group purposes, a group comprises its parent and its subsidiary undertakings but excludes investments in associates and joint ventures as well as investors who account for the reporting entity as an associate or joint venture.

S384(2) and s467(2), Companies Act 2006 states that a group becomes an ineligible group if any of its members is:

(a) *a traded company,*

(b) *[For periods commencing on or after 1 January 2021] a body corporate (other than a company) whose shares are admitted to trading on a UK regulated market, or [For periods commencing before 1 January 2021] a body corporate (other than a company) whose shares are admitted to trading on a regulated market in an EEA state, or*

(c) *a person (other than a small company) who has permission under Part 4A of the Financial Services and Markets Act 2000 (c. 8) to carry on a regulated activity, or*

(cA) *an e-money issuer; or*

(d) *a small company that is an authorised insurance company, a banking company, a MiFID investment firm or a UCITS management company, or*

(e) *a person who carries out insurance market activity, or*

(f) *a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 (interpretation of Part 1).* [18]

Note: the reference to 'UK' was inserted for periods commencing on or after 1 January 2021.

A 'UK regulated market' would be, for example, the London Stock Exchange. However, it would not include the Alternative Investment Market (AIM).

For periods commencing on or after 1 January 2021, s1173, Companies Act 2006 goes on to define a 'UK regulated market as follows:

'UK regulated market' has the meaning given in Article 2.1.13A of Regulation (EU) No. 600/20014 of the European Parliament and of the Council of 15 May 2014 and amending Regulation (EU) No. 648/2012.

For periods commencing before 1 January 2021, s1173, Companies Act 2006 goes on to define 'regulated market' as follows:

'regulated market' has the meaning given in Article 2.1.13 of Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 and amending Regulation (EU) No. 648/2012.

The amendments to Companies Act 2006 by virtue of SI 2015/980 narrowed the definition of an ineligible group. In practice, it would mean that a private company that individually meets the

[18] S384(2) and s467(2), Companies Act 2006

qualifying conditions for exemptions will not be excluded if it is a member of a group that includes a plc **unless** that company, or another entity in the group, has transferable securities admitted to trading on a UK regulated market (or, for periods commencing before 1 January 2021, a regulated market rather than a UK regulated market).

S479A, Companies Act 2006 audit exemption

In terms of audit exemption, a subsidiary may be able to claim exemption from audit at subsidiary level under Companies Act 2006, s479A *Subsidiary companies: conditions for exemptions from audit*. For periods commencing on or after 1 January 2021, s479A, Companies Act 2006 provides audit exemption for companies that are subsidiaries whose parent undertaking is established under the law of any part of the UK. There are strict conditions that must be met where the s479A exemption is concerned, which often means that, in practice, the subsidiary does not take advantage of the audit exemption.

The conditions are as follows:

(a) all members of the company must agree to the exemption in respect of the financial year in question,

(b) the parent undertaking must give a guarantee under s479C of that year,

(c) the company must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with—

- *(i) if the undertaking is a company, the requirements of Part 15 of this Act, or, if the undertaking is not a company, the legal requirements which apply to the drawing up of consolidated accounts for that undertaking, or*
- *(ii) UK-adopted international accounting standards (within the meaning given by section 474(1))*

(d) the parent undertaking must disclose in the notes to the consolidated accounts that the company is exempt from the requirements of this Act relating to the audit of individual accounts by virtue of this section, and

(e) the directors of the company must deliver to the registrar on or before the date that they file the accounts for that year –

- *(i) a written notice of the agreement referred to in subsection (2)(a),*
- *(ii) the statement referred to in section 479C(1),*
- *(iii) a copy of the consolidated accounts referred to in subsection (2)(c),*
- *(iv) a copy of the auditor's report on those accounts, and*
- *(v) a copy of the consolidated annual report drawn up by the parent undertaking.* [19]

In practice, it is the guarantee under s479(c) *Subsidiary companies audit exemption: parent undertaking declaration of guarantee,* which is the 'sting in the tail'. The guarantee is that the parent will guarantee the subsidiary's debts until they are satisfied in full. This guarantee will be enforceable against the parent undertaking by any person to whom the subsidiary is liable in respect of those liabilities.

Many parent companies are unwilling to guarantee the debts of their subsidiary and hence audit exemption cannot be taken under s479A, Companies Act 2006. However, where the parent is willing to guarantee the subsidiary's liabilities and complies with the other protocol outlined in

[19] S479A, Companies Act 2006 (extract)

s479A, audit exemption can be claimed. In such cases, a statement must be made on the face of the subsidiary's balance sheet that audit exemption under s479A has been claimed.

For periods commencing before 1 January 2021, the s479A audit exemption was wider in scope and, with similar criteria, was available where a UK **or** EEA parent prepared the consolidated financial statements and provided the guarantee.

PREPARING CONSOLIDATED FINANCIAL STATEMENTS

The requirements of FRS 102, Section 19 *Business Combinations and Goodwill* as well as Section 9 *Consolidated and Financial Statements* must be followed when preparing the consolidated financial statements of a group.

Control

The term 'control (of an entity)' is defined as:

The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.[20]

The concept of control is critical. When an investor obtains control of an investee, a parent-subsidiary relationship exists and hence a group is created.

To have control, the parent will be able to exercise a dominant influence over the subsidiary's operating and financial policies. This means that the subsidiary must carry out the wishes of the parent.

FRS 102, para 9.5 states:

Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity. That presumption may be overcome in exceptional circumstances if it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity but it has:

(a) power over more than half of the voting rights by virtue of an agreement with other investors;

(b) power to govern the financial and operating policies of the entity under a statute or an agreement;

(c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or

(d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body. [21]

'Operating' and 'financial' policies are not defined in either FRS 102 or Companies Act 2006. Such policies are not just confined to the day-to-day running of the business, but would encompass areas such as the acquisition and disposal of investments, dividend policies, financing requirements and approval of budgets and forecasts.

[20] FRS 102 Glossary: control (of an entity)
[21] FRS 102, para 9.5

Control is always based on substantive rights. Substantive rights are those rights that are exercisable at any time at the discretion of the investor.

An entity is said to have control over another entity when it owns more than 50% of the voting power of the entity. Control could, therefore, be achieved with an ownership interest of 50.01%. Only in exceptional cases would it be possible to demonstrate that control has not been obtained with an ownership interest of more than 50%, and in all cases the substance of the arrangement must be considered.

Basic elements of a consolidation

The basic mechanics of a consolidation are set out in FRS 102, para 9.13 as follows:

(a) *combine the **financial statements** of the parent and its subsidiaries line by line by adding together like items of assets, **liabilities**, **equity**, **income** and expenses;*

ACCA comment
Even when the parent does not own 100% of the subsidiary, the subsidiary's assets and liabilities are consolidated at 100% because this reflects the assets under the control of the parent and the liabilities of the group.

In terms of the consolidated profit and loss account/statement of comprehensive income, the results of the subsidiary are time-apportioned for the effect of a mid-year acquisition and this is done from the date of acquisition, which is the date on which control passes to the parent and hence is the date from which consolidation commences.

(b) *eliminate the **carrying amount** of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary;*

ACCA comment
The carrying amount of the parent's investment in each subsidiary is eliminated because this is included in the calculation of goodwill, which is presented in the consolidated balance sheet.

(c) *measure and present **non-controlling interest** in the profit or loss of consolidated subsidiaries for the **reporting period** separately from the interest of the **owners** of the parent; and*

ACCA comment
The consolidated profit and loss account/statement of comprehensive income must show the profit attributable to both the parent and the non-controlling interest at the foot of the consolidated profit and loss account/statement of comprehensive income.

(d) *measure and present non-controlling interest in the net assets of the consolidated subsidiaries separately from the parent's shareholders' equity in them. Non-controlling interest in the net assets consist of:*

  (i) *the non-controlling interest's share in the identifiable net assets (consisting of the identifiable assets, liabilities and **contingent liabilities** as recognised and measured in accordance with Section 19 Business Combinations and Goodwill, if any) at the date of the original combination; and*

  (ii) *the non-controlling interest's share of changes in equity since the date of the combination or other acquisition.*

ACCA comment
The equity section of the consolidated balance sheet shows the ownership split between the parent and the non-controlling interest. This will not, of course, be the case where the subsidiary is 100% wholly owned by the parent. In addition, FRS 102, para 9.14 requires profit or loss and changes in equity attributable to the owners of the parent and the non-controlling interest to be determined on the basis of **existing ownership interest**. The allocation at the reporting date does not reflect the potential exercise or conversion of options or convertible instruments, such as convertible loans.

Consolidated balance sheet

A summary of the above consolidation procedures for the consolidated balance sheet is shown in the following table:

Area	Method of consolidation
Assets	Amalgamate on a line-by-line basis
Liabilities	Amalgamate on a line-by-line basis
Share capital	Parent's share capital only
Reserves	Group reserves comprise: • 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 reporting date

Consolidated profit and loss account/statement of comprehensive income

In practice, preparing the consolidated profit and loss account/statement of comprehensive income is less complex than the consolidated balance sheet.

The results of the subsidiary are consolidated line-by-line up to the level of profit after tax. At the foot of the consolidated profit and loss account/statement of comprehensive income, the profit (or loss) is presented as the amount due to the parent of the group and the amount due to the non-controlling interest.

Illustration: consolidated profit and loss account

Sunnie Group Ltd
Consolidated profit and loss account
For the year ended 31 October 2021

	31.10.2021	**31.10.2020**
	£'000	**£'000**
Turnover	13,100	14,200
Cost of sales	(7,120)	(7,970)
Gross profit	**5,980**	**6,230**
Distribution costs	(1,141)	(1,320)
Administrative expenses	(2,020)	(2,130)
Interest payable and similar expenses	(950)	(980)
Profit before tax	**1,869**	**1,800**

Tax on profit	(355)	(342)
Profit for the year	**1,514**	**1,458**
Profit attributable to:		
Owners of the parent	1,211	1,166
Non-controlling interest	303	292
	1,514	1,458

Elimination of intra-group transactions and balances

The requirement to prepare consolidated financial statements that show the results of the group as a single reporting entity means that intra-group balances and transactions must be eliminated.

Intra-group balances and transactions and profits and losses arising from intra-group transactions recognised in assets such as inventory and property, plant and equipment must be eliminated in full on consolidation. If such items are not eliminated, the consolidated financial statements will not present a true and fair view, and hence would be misleading. In addition, FRS 102, para 9.15 requires deferred tax issues to be considered where timing difference arise from the elimination of profits and losses resulting from intra-group transactions.

In practice, agreeing intra-group balances can be an arduous process for some groups – particularly large ones. If intra-group balances do not immediately contra, a common cause is 'in-transit items', including cash.

It should also be noted that intra-group losses may indicate an impairment that requires recognition in the consolidated financial statements is needed.

Intra-group finance costs and dividends

It is common for groups to make loans to other members of the group – for example, a parent may make a loan to its subsidiary.

If there is a loan outstanding between group members, the effect of any finance costs (loan interest) received and paid must be eliminated from the consolidated profit and loss account.

The relevant amount of interest must be deducted from group investment income and group finance costs.

Dividends paid in the consolidated financial statements must only reflect those paid to the non-controlling interests. A payment of a dividend paid by the subsidiary to its parent will need to be cancelled. The effect on the consolidated financial statements is as follows:

(a) Only dividends paid by the parent to its own shareholders appear in the consolidated financial statements. These are presented in the consolidated statement of changes in equity.

(b) Any dividend income shown in the consolidated profit and loss account/statement of comprehensive income must arise from investments other than those in subsidiaries.

Unrealised profits and losses

Group members often trade with each other and, in such situations, the selling entity may recognise a profit element in a sale. Where such intra-group sales and purchases arise and some, or all, of the goods are still in the entity's inventory valuation at the reporting date, the cost to the buying member will often include the selling member's profit element. From a group perspective, such profits are not realised until the goods are sold outside of the group and hence must be removed during the consolidation process.

It should be emphasised that unrealised profits and losses are not simply confined to sales of stock; they can also arise when fixed assets are sold among group members.

When goods are sold between group members in a group with a non-controlling interest, there are two possible approaches that the parent could take in showing the profit attributable to the non-controlling interest in the consolidated financial statements:

- Allocate the non-controlling interest's proportionate share of the unrealised profit. This has the effect of eliminating the profit in the selling group member's financial statements.
- Allocate no part of the unrealised profit to the non-controlling interest. This reflects the non-controlling interest's entitlement to their full share of the profit arising on the intra-group sale.

FRS 102 does not specify either approach and, in practice, both methods are equally acceptable.

Example: elimination of intra-group profit in stock

The Wolves Group consists of a parent and one wholly owned subsidiary. During the year to 31 October 2021, the parent sold goods costing £10,000 to the subsidiary for £15,000. At the year end 31 October 2021, the subsidiary had half of these goods left in inventory.

Intra-group sale and purchase

The intra-group sale and purchase must be eliminated on consolidation as follows:

Dr Revenue £15,000
Cr Cost of sales £15,000
Elimination of intra-group sale

Intra-group profit in inventory

At the year end, the subsidiary had half of the goods sold through the intra-group sale in inventory. This means that the subsidiary's inventory includes £7,500 worth of inventory at cost to the subsidiary.

However, the parent sold the goods at a profit of £5,000 (£15,000 sale to subsidiary at an original cost £10,000) and so the subsidiary's inventory valuation will include this element of profit (an unrealised profit). To comply with the principles of FRS 102, Section 13 *Inventory*, the consolidated inventory balance must be reduced. In the example, this is by £2,500 (£5,000 profit x 50%) to bring the group inventory still held back down to cost to the group. If this unrealised profit were not eliminated, the consolidated inventory valuation would be overstated.

To eliminate the unrealised profit in inventory, the consolidation adjustment is recorded as follows:

Dr Cost of sales £2,500
Cr Inventory £2,500
Being elimination of unrealised profit in inventory at the reporting date

Uniform reporting date

The financial statements of the parent and its subsidiaries should be prepared to the same reporting date unless it is impracticable to do so.

The term 'impracticable' is defined in the Glossary to FRS 102 as follows:

Applying a requirement is impracticable when the entity cannot apply it after making ever reasonable effort to do so.'[22]

In addition, s390 *A company's financial year* of Companies Act 2006 states:

The directors of a parent company must secure that, except where in their opinion there are good reasons against it, the financial year of each of its subsidiary undertakings coincides with the company's own financial year.[23]

This section of Companies Act 2006 imposes an obligation on the directors of a parent to ensure coterminous accounting reference dates rather than imposing obligations over the preparation of the consolidated financial statements.

There may be good reasons that a subsidiary undertaking may have a difference accounting reference date to that of its parent, including:

- a subsidiary located overseas may be legally required to have a certain accounting reference date
- seasonal trends
- tax reasons.

FRS 102 is consistent with the requirements of Companies Act 2006, sch 6(2)(2), which outlines the position when a subsidiary's accounting reference date is not coterminous with the parent's.

In practice, it is not difficult to change a company's accounting reference date. This is done easily by submitting form AA01 or online to Companies House; hence, it will be uncommon for subsidiaries to have a different accounting reference date from their parent on the grounds of impracticability.

Accounting reference dates can be shortened as often as the entity wishes. However, an accounting period cannot be lengthened more than once in a five-year timescale. Following Brexit, UK subsidiaries can no longer routinely extend their accounting reference date to align with an EEA parent and the five-year rule will apply.

In situations where the reporting date and reporting period of a subsidiary are not the same as those of the parent, the consolidated financial statements are made up in one of two ways:

- by combining the financial statements of the subsidiary made up to an earlier date than that of the parent and adjusting for the effect of significant transactions or events between the two reporting dates – provided that the reporting date of the subsidiary is no more than three months before that of the parent
- using interim financial statements prepared by the subsidiary and made up to the parent's reporting date.

[22] FRS 102 Glossary **impracticable**
[23] Companies Act 2006, s390

FRS 102, para 9.16 refers to 'significant transactions or events' but does not go on to define them. This is, therefore, down to professional judgment but typical examples may be a significant bad debt, loss of significant assets due to catastrophe or significant restructuring.

Where a subsidiary's accounting reference date is different from that of its parent, disclosure of the difference should be made in the consolidated financial statements.

Example: non-coterminous reporting dates

The Arlo Group Ltd is preparing consolidated financial statements for the year ended 31 December 2021. One of its subsidiaries makes up its individual financial statements to 30 September 2021.

The group has two options:

- The **preferred option** is to include nine months of the results of the subsidiary for the period from 1 January 2021 to 30 September 2021 and three months of the unaudited results based on interim management accounts for the period 1 October 2021 to 31 December 2021.
- An alternative option would be to consolidate the full-year accounts for the year to 30 September 2021 and make adjustments for any significant transactions of the subsidiary between 1 October 2021 and 31 December 2021.

Uniform accounting policies

FRS 102, para 9.17 states that the consolidated financial statements of a group are to be prepared using uniform accounting policies for like transactions and other events and conditions in similar circumstances.

Where a member of a group uses accounting policies other than those adopted in the consolidated financial statements for like transactions, appropriate adjustments should be made when preparing the consolidated financial statements. This may apply, for example, in the case of a UK group reporting under FRS 102, which has a US-based subsidiary that prepares its individual financial statements under US GAAP.

In practice, some groups that adopt different accounting policies or report under different GAAPs often require a reconciliation of the subsidiary's financial statements to what would be reported had the subsidiary prepared their financial statements in accordance with the parent's GAAP and applied the parent's accounting policies. For example, a parent reporting under UK-adopted IFRS is required to capitalise development expenditure that meets the recognition criteria in IAS 38, *Intangible Assets*, whereas a subsidiary reporting under FRS 102 may choose to write off such expenditure as an accounting policy choice under FRS 102 for commercial reasons.

The Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), Sch 6(3) makes provision for different accounting policies applied by a subsidiary and specifically requires adjustments to be made in the consolidated financial statements. However, there are two exceptions to this rule in the Regulations (SI 2008/410, Sch 6, para 3(2) and (3)):

- where, in the opinion of the directors, there are special reasons for the application of different accounting policies, and disclosure is made of the fact that different policies have been used, together with the reasons and the effects of the differing policies
- where any consolidation adjustments would be immaterial for the purpose of giving a true and fair view.

FRS 102 does not refer to ‘special reasons’ or the situation where the directors may consider it appropriate to adopt differing accounting policies for like transactions and events in similar circumstances. Therefore, it would be appropriate to make consolidation adjustments in the consolidated financial statements to align the policies to those of the group.

PURCHASE METHOD OF ACCOUNTING

FRS 102 requires all business combinations to be accounted for using the purchase method of accounting. (This is also referred to the as ‘acquisition method of accounting’ in company law.) This method is set out in FRS 102, para 19.7 as follows:

(a) identifying an acquirer;

ACCA comment
The acquirer is generally the party that obtains control of the acquiree. Control will be based on substantive rights and, in the event that the acquirer cannot be identified immediately, FRS 102, para 19.10 provides some indicators as to how to identify the acquirer.

(aA) determining the acquisition date;

ACCA comment
FRS 102 requires the purchase method of accounting to be applied from the date of acquisition, which is the date on which the parent acquires control of the subsidiary.

FRS 102, para 19.10A does not require a transaction to be completed in law before the acquirer obtains control. This is because there could be situations, and clauses within the transaction, where the acquirer could obtain control on a date that is either earlier or later than the legal completion date. It will therefore be necessary to carefully scrutinise the agreement to establish the acquisition date because this is the date on which the acquiree’s assets and liabilities are consolidated by the parent.

(b) measuring the cost of the business combination;

ACCA comment
According to FRS 102, para 19.11, the cost of the combination is the aggregate of the fair values of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control, plus directly attributable costs of the acquisition.

Directly attributable costs will include costs such as legal fees and due diligence fees. These are capitalised as part of the cost of the acquisition rather than written off to profit or loss as required by IFRS 3, *Business Combinations.*

(c) allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and ***provisions*** *for* ***contingent liabilities*** *assumed and recognising and measuring any* ***non-controlling interest*** *in the acquiree; and*

ACCA comment
The cost of the business combination is allocated to the assets acquired and the liabilities and provisions for contingent liabilities assumed. Contingent liabilities are also recognised by the acquirer where the fair value of these can be measured reliably.

When a subsidiary is not wholly owned, non-controlling interest (or 'minority interest' as it is frequently referred to in the UK) will arise. Non-controlling interest (NCI) is the external shareholders who own the remainder of the shares outside of the group.

NCI must be recognised in the group balance sheet and their share of the profit of the subsidiary must be disclosed on the face of the group profit and loss account. This is because where NCI arises, the parent does not enjoy a 100% ownership interest in the subsidiary's net assets. The NCI in the group balance sheet reflects an ownership interest in the group's net assets that is not attributable to the parent company. In addition, it is also reflected because if it is not, the group balance sheet will not balance.

Appendix 2 shows an illustration of a non-wholly owned subsidiary.

*(d) recognising and measuring **goodwill**.*[24]

ACCA comment
Goodwill is examined in section 4.

Deferred consideration

Often, when an acquirer obtains control of an acquiree, there will be clauses within the agreement that give rise to deferred consideration. For example, the acquirer obtains control and a portion of the consideration is held back to be paid to the ex-shareholders at a future date.

Where deferred consideration is concerned, this should be discounted to present value where the effects of discounting are material. The rate at which the deferred consideration should be discounted should be the rate at which the acquirer would obtain for a similar borrowing, such as the rate of interest the bank would charge the acquirer.

Example: discounted deferred consideration
Harper Ltd acquired 100% of the net assets of Tennyson Ltd on 30 April 2021. The purchase price was £2.6m. At the date of acquisition, Harper transferred £1.9m to the shareholders of Tennyson and the balance of £700,000 is to be paid in two years' time. The financial controller has obtained a quotation from its bank and if they were to take out a £700,000 bank loan for two years on 30 April 2021, the bank would charge interest at a rate of 6%.

The deferred consideration amount should be discounted to present value using a rate of 6%, being the market rate that the bank would charge for an equivalent loan. This gives a present value of £622,998 (£700,000/1.06^2). The difference of £77,002 should be charged to profit or loss as interest payable and similar expenses over the two-year period.

There is no adjustment to goodwill, regardless of the fact that the interest rate might change prior to the deferred consideration being paid.

The deferred consideration is profiled as follows:

[24] FRS 102, para 19.7

Balance b/f	Interest @ 6%	Cashflow	Balance c/f
£	**£**	**£**	**£**
622,998	37,380	-	660,378
660,378	39,622	(700,000)	-

The entries in the books of Harper Ltd will be as follows:

Year 1	£
Dr Fixed asset investment	622,998
Cr Deferred consideration	622,998
Being deferred consideration on acquisition of Tennyson	
Dr Interest payable	37,380
Cr Deferred consideration	37,380
Being unwinding of the discount in year 1	
Year 2	
Dr Interest payable	39,622
Cr Deferred consideration	39,622
Being unwinding of the discount in year 2	
Dr Deferred consideration	700,000
Cr Cash at bank	700,000
Being final payment to ex-shareholders of Tennyson Ltd	

Contingent consideration

The sale-purchase agreement may make provision for the buyer to transfer further consideration to the ex-shareholders at a future point in time, provided certain conditions have occurred (or not occurred as the case may be). In practice, the most common type of occurrence that would trigger further consideration being paid by the purchaser is the achievement of a certain level of profit by the acquiree post-acquisition.

FRS 102, para 19.12 states that when a business combination agreement makes provision for an adjustment to the cost of the combination that is based on future events, the acquirer includes an estimated amount of that adjustment in the cost of the combination at the date of acquisition. The acquirer can only make an adjustment in respect of contingent consideration where it is *probable* (ie more likely than not) that the contingent consideration will be paid and the amount can be reliably measured. In addition, the time value of money must be taken into consideration, if material.

If, at the date of acquisition, the acquirer concludes that it is not probable that the contingent consideration will be paid, but subsequently it does become probable, then the additional consideration is treated as an adjustment to the cost of the business combination.

Example: contingent consideration

Warrington Ltd acquires 100% of Wolves Ltd. The sale-purchase agreement makes provision for the consideration as follows:

(a) an immediate payment of £2m; and
(b) a further payment of £0.5m if profit before interest and tax exceeds £700,000 in the first year post-acquisition. The £0.5m will be held in an escrow account on completion of the transaction.

The payment in (b) is contingent on Wolves Ltd achieving a benchmark profit target and hence is treated as contingent consideration. Whether the contingent consideration is recognised as part of the business combination would all depend on if it is probable that payment will be made and hence will require consideration of all available information, such as budgets and forecasts. This will mean that Warrington recognises either £500,000 or £nil. If budgets and forecasts indicate that the benchmark profit will be achieved, then the £500,000 is recognised; if not, it is not recognised.

At the date of acquisition, Warrington did not expect that it would be probable that the £500,000 contingent consideration would be paid and hence was not included in the cost of the business combination. However, in the third quarter of the year, it did become probable that the contingent consideration would be paid.

If, subsequent to the accounting for the business combination, it becomes probable that contingent consideration will be paid, it is brought into the cost of the business combination with a corresponding adjustment to goodwill, hence:

Dr Goodwill	£500,000
Cr Liability	£500,000 (usually as a current liability)

The above examples demonstrate the application of FRS 102, para 19.13. It should be emphasised that under FRS 102, there is no time limit where adjustments to the cost of a business combination are concerned, although there is a one-year time limit to the adjustment of fair values of assets and liabilities acquired and assumed. Therefore, goodwill could go up or down depending on the treatment of contingent consideration as and when events unfold.

The question then arises as to what should happen in terms of accounting treatment for the unwinding of the discount (ie the difference between the present value and the amount that will be paid). FRS 102, para 19.13B clarifies that the unwinding of any discount is to be recognised as a finance cost in profit or loss in the period in which it arises. This is consistent with the underlying principles in other areas of FRS 102, which require discounting to be applied when it is material (for example, Section 21 *Provisions and Contingencies*).

GOODWILL

The final stage in applying the purchase method of accounting is for the acquirer to recognise and measure goodwill.

Where the cost of a business combination exceeds the net assets acquired, positive goodwill is recognised. Conversely, where the net assets acquired exceeds the consideration, this gives rise to a 'bargain' purchase and negative goodwill arises. Negative goodwill is examined below.

Goodwill under FRS 102 is not included in the same section as intangible assets (Section 18 *Intangible Assets other than Goodwill*). This is because internally generated goodwill is never recognised on the balance sheet under any circumstances and, to reinforce this principle, goodwill is dealt with in Section 19.

In addition, the Companies Act 2006 only permits goodwill to be recognised on the balance sheet to the extent that it was acquired for valuable consideration.

Initial recognition of goodwill

FRS 102, para 19.22 requires an acquirer, at the date of acquisition, to:

(a) *recognise goodwill acquired in a business combination as an asset; and*

(b) *initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with paragraphs 19.15 to 19.15C.* [25]

The default 'template' for calculating goodwill is as follows:

	£
Cost of investment	X
Less net assets acquired	(X)
Goodwill	X

Example: goodwill on acquisition of a subsidiary

Bolton Ltd acquires 80% of the net assets of Wanderers Ltd on 1 January 2021 for £75,000. At the date of acquisition, the fair value of the net assets of Wanderers Ltd is as follows:

	£
Share capital	1,000
Share premium	1,500
Revaluation reserve	15,000
Retained earnings	65,000
	82,500

Goodwill arising on acquisition is calculated as follows:

	£	£
Cost of investment		75,000
Net assets acquired (80%):		
• Share capital	800	
• Share premium	1,200	
• Revaluation reserve	12,000	
• Retained earnings	52,000	
		(66,000)
Goodwill		9,000

In the above example, the individual financial statements of Bolton Ltd will show the cost of the investment in Wanderers of £75,000 within fixed assets as a long-term investment. In the

[25] FRS 102 para 19.22 (a) and (b)

consolidated financial statements, this investment is removed and is cancelled against the net assets acquired and is replaced with the goodwill figure of £9,000.

Subsequent measurement of goodwill

After initial recognition, goodwill is always measured at cost less accumulated amortisation and accumulated impairment losses.

FRS 102 requires all goodwill (and other intangible assets) to be amortised on a systematic basis over their useful economic lives. There is no option under FRS 102 to assign indefinite useful lives to goodwill or intangible assets.

FRS 102, para 19.23(a) confirms that goodwill cannot have an indefinite useful life. In exceptional cases, when management are unable to make a reliable estimate of the useful life of goodwill, the amortisation period must not exceed 10 years.

This is a notable difference from IFRS 3. IFRS 3 requires management to undertake annual impairment reviews of goodwill; there is no option under the IFRS to amortise goodwill. FRS 102 is more restrictive in that it does not permit indefinite useful lives to be assigned and hence goodwill must be amortised on a systematic basis over that useful economic life. This does not preclude management from undertaking an impairment test on goodwill, which must be carried out if there is any indication that goodwill is impaired (see below).

Where goodwill is impaired and is written down to recoverable amount by way of an impairment loss (calculated in accordance with FRS 102, Section 27 *Impairment of Assets*), that goodwill impairment loss can never be reversed in a subsequent period (FRS 102, para 27.28).

Impairment of goodwill

In a group context, a subsidiary is generally classed as a cash-generating unit (CGU). FRS 102, para 27.26 says:

Part of the recoverable amount of a cash-generating unit is attributable to the ***non-controlling interest (NCI)*** *in goodwill. For the purpose of impairment testing of a non-wholly-owned cash-generating unit with goodwill, the carrying amount of that unit is notionally adjusted, before being compared with its recoverable amount, by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the non-controlling interest. This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.* [26]

Therefore, where the parent does not wholly own a subsidiary, FRS 102, para 27.26 requires the goodwill to be grossed up to include the goodwill attributable to the NCI. This grossing up calculation is done **before** conducting the impairment review because it is the notionally adjusted goodwill figure that is then aggregated with the other net assets of the CGU. The aggregate amount is then compared to recoverable amount to determine the value of any write-down.

Example: notionally adjusted goodwill

Topco Ltd owns 80% of Subco Ltd and the group has an accounting reference date of 31 March each year. On 31 March 2022, the carrying amount of Subco's net assets was £880,000, excluding goodwill of £120,000 (net of amortisation). Management decided to restructure the group and announced this restructuring exercise immediately prior to the reporting date.

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

[26] FRS 102, para 27.26

FRS 102, para 27.26 requires Topco to notionally adjust the goodwill to take into account the NCI. The impairment loss is calculated as follows:

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

80% of the impairment loss is allocated to the group so an impairment loss of £64,000 (£80,000 x 80%) is recognised in Topco's consolidated financial statements. This impairment loss cannot be reversed in a subsequent accounting period, even if the circumstances giving rise to the original impairment loss cease to apply.

Order of allocation of an impairment loss

The order in which an impairment loss is to be allocated to a CGU is prescribed in FRS 102, para 27.21, which states:

An impairment loss shall be recognised for a cash-generating unit if, and only if, the recoverable amount of the unit is less than the carrying amount of the unit. The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit in the following order:

(a) first, to reduce the carrying amount of any ***goodwill*** *allocated to the cash generating unit; and*

(b) then, to the other assets of the unit pro rata on the basis of the carrying amount of each asset in the cash-generating unit.[27]

Care needs to be taken when dealing with such impairment losses because there is a restriction in FRS 102, para 27.22, which states that an entity cannot reduce the carrying amount of any asset in a CGU below the **highest** of:

(a) its fair value less costs to sell (if determinable)
(b) its value in use (if determinable)
(c) zero.

FRS 102, para 27.23 then goes on to say that any excess amount of the impairment loss which cannot be allocated to an asset because of the above restriction must be allocated to the other assets of the unit pro rata on the basis of the carrying amount of those other assets.

[27] FRS 102, para 27.1

Example – Allocating an impairment loss

The Ratchford Group is a clothing retailer. One of its subsidiaries, Jobling Clothing Ltd, suffered a fire and management have decided to close the store permanently and redeploy staff to other stores. The loss adjuster has determined that 40% of the machinery has been destroyed but the remaining 60% can be sold. The carrying amount of Jobling's assets are as follows:

	£'000
Goodwill	100
Licences	250
Machinery	850
Other fixed assets	220
Vehicles	48
Building	1,500
Cash at bank	82
	3,050

An independent surveyor has suggested a selling price of £1.6m could be achieved for the building. The finance director has calculated a recoverable amount for the CGU (being the subsidiary) of £2.5m. 40% of the machinery was destroyed in the fire, hence 40% of the carrying amount must be written off immediately (ie £340,000). This leaves a carrying amount for the machinery of £510,000 (£850k – £340k).

The total carrying amount of the CGU after impairment of the machinery is £2,710,000 (see below). Recoverable amount is £2.5m so a further impairment loss of £210,000 is needed.

This is allocated first to goodwill and then to the other assets in the CGU on a pro rata basis (FRS 102, para 27.21). Goodwill of £100,000 is written off in full, leaving £110,000 to allocate. Therefore, for example, the amount attributable to licences if £53,000 ((£250,000 / (£250,000 + £220,000 + £48,000)) x £110,000).

There should be no further impairment loss allocated to the machinery because these have already been written down to their recoverable amount. In addition, the impairment loss cannot be set against the building because its fair value is greater than its carrying amount (£1.6m as suggested by the independent surveyor), hence the restriction in FRS 102, para 27.22(a) applies. The monetary asset (cash at bank) is also not affected by the impairment loss because this will be realised at full value.

The impairment loss is allocated as follows:

	Post machinery impairment	**Further impairment**	**Post impairment**
	£'000	£'000	£'000
Goodwill	100	(100)	–
Licences	250	(53)	197
Machinery	510	–	510
Other fixed assets	220	(47)	173
Vehicles	48	(10)	38
Building	1,500	–	1,500
Cash at bank	82	–	82
	2,710	(210)	2,500

Negative goodwill

In the majority of cases, it is likely that positive goodwill will arise in the consolidated financial statements as generally the consideration paid in the business combination will be in excess of the net assets acquired. However, this is not necessarily always the case in every business combination, and there may be circumstances that give rise to a 'bargain' purchase, ie where the consideration paid to acquire the business is *less* than the fair value of the net assets acquired. This usually (but not always) takes place in a distressed sale, where a company is in financial distress and the outgoing shareholders agree to sell the company to an acquirer at less than the fair value of the net assets.

Negative goodwill is dealt with in FRS 102, para 19.24. This paragraph takes a different approach when compared to IFRS 3, which requires negative goodwill to be immediately recognised in profit or loss. When negative goodwill appears to arise, there are three steps which take place according to FRS 102, para 19.24:

(a) *Reassess the identification and **measurement** of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination.*

(b) *Recognise and separately disclose the resulting excess on the face of the **statement of financial position** on the acquisition date, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess.*

(c) *Recognise subsequently the excess up to the fair value of non-monetary assets acquired in **profit or loss** in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired shall be recognised in profit or loss in the periods expected to be benefited.* [28]

Professional judgement will be needed where (b) and (c) are concerned. For example, an acquirer may decide to allocate the excess on a pro-rata basis, or to allocate the excess to specific assets where these can be identified. In practice, amounts that are allocated to, say, stock (inventory) will be eliminated quickly, whereas amounts allocated to fixed assets may take a longer period of time to eliminate depending on depreciation policies.

INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION

Intangible assets are dealt with in FRS 102, Section 18 *Intangible Assets other than Goodwill*. FRS 102, para 18.8 was redrafted as part of the FRC's triennial review in 2017. The objective of this redrafting exercise was to reduce the burdens placed on businesses that undertook a business combination. Prior to the amendments, FRS 102 required separate identification of intangible assets outside of goodwill. In practice, this proved to be arduous to groups and resulted in extra costs being incurred in searching for additional intangible assets that may have been acquired as a result of a business combination. The redrafted paragraph 18.8 means that an entity can elect to recognise fewer intangible assets on the consolidated balance sheet and the excess can be subsumed within goodwill. This revised paragraph has been welcomed by groups.

FRS 102, para 18.8 states that intangible assets which are acquired in a business combination shall be recognised separately from goodwill when:

(a) the recognition criteria set out in paragraph 18.4 are met

[28] FRS 102, paras 19.24(a)-(c)

(b) the intangible asset arises from contractual or other legal rights

(c) the intangible asset is separable (ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or liability).

FRS 102, para 18.8 does state that an entity can continue to recognise separately intangible assets from goodwill for which condition (a) and only one of (b) or (c) above is met. However, such a policy must then be applied to all intangible assets in the same asset class and be applied consistently to all business combinations.

APPENDIX 1
Example: consolidation of a wholly owned subsidiary

Senario:

- H Ltd acquired all the shares in S Ltd on 31 December 2020 for £5m
- Goodwill is amortised on a five-year straight-line basis
- Fair value of the net assets in S Ltd at 31 December 2020 was £3,450,000
- Profit of S Ltd for the year ended 31 December 2021 was £650,000

		H Ltd £'000	S Ltd £'000	Consolidation adjustment £'000	Group £'000
Balance sheet as at 31 December 2021					
Fixed assets					
Goodwill	See W1 below			1,550	1,550
Goodwill amortisation	See W2 below			(310)	(310)
Investment in S Ltd		5,000		(5,000)	
Property, plant and equipment		1,000	3,000		4,000
Sub-total		6,000	3,000	(3,760)	5,240
Current assets					
Inter-group debtor		2,400	900	(3,300)	
Other current assets		1,600	2,700		4,300
Sub-total		4,000	3,600	(3,300)	4,300
Current liabilities					
Inter-group creditor		(900)	(2,400)	3,300	
Other current liabilities		(600)	(100)		(700)
Sub-total		(1,500)	(2,500)	3,300	(700)
Net assets		**8,500**	**4,100**	**(3,760)**	**8,840**
Capital and reserves					
Ordinary shares		2,000	1,000	(1,000)	2,000
Retained earnings	Pre-acquisition	5,300	2,450	(2,450)	5,300
	Post-acquisition	1,200	650	(310)	1,540
		8,500	**4,100**	**(3,760)**	**8,840**

Profit and loss accounts For the year ended 31 December 2021		H Ltd £'000	S Ltd £'000	Consolidation adjustment £'000	Group £'000
Turnover	External	10,000	4,000		14,000
	Group	1,600	2,000	(3,600)	
Cost of sales	External	(7,500)	(3,100)		(10,600)
	Group	(2,000)	(1,600)	3,600	
Gross profit		**2,100**	**1,300**		**3,400**
Administrative expenses		(700)	(500)	(310)	(1,510)

Profit before tax	**1,400**	**800**	**(310)**	**1,890**
Tax on profit	(200)	(150)		(350)
Profit after tax	**1,200**	**650**	**(310)**	**1,540**

Workings

W1: Goodwill on acquisition	£'000
Cost of investment in S Ltd	5,000
Net assets acquired	(3,450)
Goodwill on acquisition of S Ltd	1,550

W2: Goodwill amortisation	
Goodwill arising	1,550
Amortisation policy	5 years SL
Amortisation for the year	310

APPENDIX 2
Example: Consolidation of a non-wholly owned subsidiary

Senario:

- H Ltd acquired 80% of S Ltd on 31 December 2020 for £4m
- Goodwill is amortised over five years on a straight-line basis
- Share capital of S Ltd at 31 December 2020 was £1m
- Retained earnings of S Ltd at 31 December 2020 was £2,450,000

		H Ltd £'000	S Ltd £'000	Consolidation adjustment £'000	Group £'000
Balance sheet as at 31 December 2021					
Fixed assets					
Goodwill	See W1 below			1,240	1,240
Amortisation of goodwill	See W1 below			(248)	(248)
Investment in S Ltd		4,000		(4,000)	
Property, plant and equipment		1,000	3,000		4,000
Sub-total		5,000	3,000	(3,008)	4,992
Current assets					
Inter-group debtor		2,400	900	(3,300)	
Other current assets		2,600	2,700		5,300
Sub-total		5,000	3,600	(3,300)	5,300
Current liabilities					
Inter-group creditor		(900)	(2,400)	3,300	
Other current liabilities		(600)	(100)		(700)
Sub-total		(1,500)	(2,500)	3,300	(700)
Net assets		8,500	4,100	(3,008)	9,592
Capital and reserves					
Ordinary shares		2,000	1,000	(1,000)	2,000
Retained earnings	See W2 below	6,500	3,100	(2,828)	6,772
Non-controlling interest	See W3 below			820	820
		8,500	**4,100**	**(3,008)**	**9,592**

Profit and loss account For the year ended 31 December 2021		H Ltd £'000	S Ltd £'000	Consolidation adjustment £'000	Group £'000
Turnover	External	10,000	4,000		14,000
	Group	1,600	2,000	(3,600)	
Cost of sales	External	(7,500)	(3,100)		(10,600)
	Group	(2,000)	(1,600)	3,600	
Gross profit		**2,100**	**1,300**		**3,400**
Administrative expenses		(700)	(500)	(248)	(1,448)

Profit before tax	**1,400**	**800**	**(248)**	**1,952**
Tax on profit	(200)	(150)		(350)
Profit after tax	**1,200**	**650**	**(248)**	**1,602**

Profit attributable to:

Owners of the parent	520
Non-controlling interest	130
	650

Workings	**£'000**	**£'000**	
W1 - Goodwill			
Cost of investment		4,000	
Net assets acquired (80%)			
Share capital	800		
Retained earnings	1,960		
		(2,760)	
Goodwill on acquisition		1,240	
Amortisation (5 years SL)		(248)	To group retained earnings
Per group balance sheet		992	
W2 - Group retained earnings			
Opening parent retained earnings	5,300		
P profit for the year	1,200		
		6,500	
Share of subsidiary profit (£650 x 80%)		520	
Goodwill amortisation (see W1)		(248)	
Per group balance sheet		6,772	
W3 - Non-controlling interest			
At date of acquisition (£3,450 x 20%)		690	
Share of subsidiary's profit (£650 x 20%)		130	
Per group balance sheet		820	