In Malaysia, the accounting standards that govern the preparation and presentation of consolidated financial statements are:

(a) MFRS 3 Business Combinations;

(b) MFRS 10 Consolidated Financial Statements;

(c) MFRS 11 Joint Arrangements;

(d) MFRS 12 Disclosure of Interests in Other Entities;

(e) MFRS 127 Separate Financial Statements; and

(f) MFRS 128 Investments in Associates and Joint Ventures.

MFRS 3 is effective for annual periods beginning on or after 1 January 2012. MFRS 10, MFRS 11, MFRS 12, MFRS 127 and MFRS 128 are effective for annual periods beginning on or after 1 January 2013.

The transition provisions of MFRS 10 are discussed in section 1.7 ''Appendix B'' of this chapter.

1.2 WHO HAS TO PRESENT CONSOLIDATED FINANCIAL STATEMENTS

MFRS 10 requires an entity that is a parent to present consolidated financial statements (paragraph 4).

(A parent is defined in MFRS 10 as an entity that controls one or more entities. The concept of control is discussed in section 1.6 ''Appendix A'' of this chapter. For purpose of discussions in this book, an entity that holds more than 50% of the issued share capital of another is assumed to have control and is therefore the parent, unless specified otherwise.)

However, a parent that is itself a subsidiary of another entity need not present consolidated financial statement if all the following conditions are met (paragraph 4 (a)):

(i) It is itself a wholly owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners do not object to the parent not presenting consolidated financial statements;

(ii) Its debt or equity instruments are not traded in a stock exchange;

(iii) It did not file, nor is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any debt and equity Instruments; and

(iv) Its ultimate or any intermediate parent produces consolidated financial statements that are available for public use.

Notwithstanding paragraph 4 (a), MFRS 10 requires the ultimate Malaysian parent to present consolidated financial statements (para 4AA).

Illustration 1.1

Scenario I

A Bhd is the parent of B Bhd.

In this case, A Bhd must present consolidated financial statements.

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Scenario II

D Bhd is the parent of E Bhd, which, in turn, is the parent of F Bhd

In this case, E Bhd need not present consolidated financial statements if all the conditions in paragraph 4 (a) are met. D Bhd must present consolidated financial statements.

Scenario III

K Bhd is the parent of L Bhd. L Bhd is the parent of M Bhd. M Bhd is the parent of N Bhd.

In this case, L Bhd and M Bhd need not present consolidated financial statements if all the conditions in paragraph 4 (a) are met. K Bhd must present consolidated financial statements.

Scenario IV

W Ltd (a company incorporated in Australia) is the parent of X Bhd. X Bhd is the parent of Y Bhd. Y Bhd is the parent of Z Bhd.

In this case, Y Bhd need not present consolidated financial statements if all the conditions in paragraph 4 (a) are met. X Bhd, being the ultimate Malaysian parent, is required to present consolidated financial statements (para 4AA).

(Note: The international financial reporting standard IFRS 10, on which MFRS 10 is based, does not contain paragraph 4AA.)

It may be noted that, if all the conditions in paragraph 4 (a) are met, the intermediate parent's consolidated financial statements will be of very little use, and are therefore exempted.

Effective 1 January 2014, a parent which qualifies as an ''investee entity'' (see paragraph 27) need not presented consolidated financial statements.

1.3 CONSOLIDATION PROCEDURE

There are two basic methods of consolidation, namely, the acquisition method (also referred to as the purchase method), and the pooling-of-interest method (also referred to as the merger method). However, since the acquisition method is by far the more commonly used method in practice, and that MFRS 3 has disallowed the use of the pooling-of-interest method in almost all consolidations, this book adopts the acquisition method. (The pooling-of-interest method is briefly discussed in Chapter 10 of this book.)

In preparing consolidated financial statements under the acquisition method, the financial statements of the parent and subsidiaries in a group are combined under the ''full consolidation'' principle, on a line by line basis and on 100% basis, by adding together like items of assets, liabilities, equity, revenue and expenses. The investment account should, however, be eliminated against the pre-acquisition equity of the subsidiaries so as to avoid double counting.

Where the parent has less than 100% interest in a subsidiary, the interest of the outside shareholders in the subsidiary (non-controlling interest) must be accounted for and shown separately in the consolidated financial statements.

All the assets and liabilities of the subsidiary (including those that are not recognised by the subsidiary) at the acquisition date should be recognised and fair valued, and the difference, if any, between the cost of investment and the fair value of the identifiable net assets acquired (goodwill) should also be accounted for.

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Where there are intragroup transactions, the account balances must be eliminated. Profits and losses arising therefrom may be unrealised from the group's viewpoint and therefore must also be eliminated.

In more complex situations where there are many consolidation adjustments required, it may be necessary to adopt a set procedure so that the sequence of thought and the procedure of preparation can be logically carried out. One logical sequence that is adopted in this book is as follows: (i) elimination of Investment account; (ii) elimination of intragroup items; and (iii) recording of non-controlling interest.

Consolidated financial statements should be prepared using uniform accounting policies for like transactions and events in similar circumstances. In cases where a subsidiary is operating overseas and has adopted accounting standards that are not the same as those adopted by the parent, the financial statements of the subsidiary will have to be adjusted to comply with the accounting standards adopted by the parent before consolidation.

The financial statements of all the entities in a group should be based on same accounting period. When the financial statements of the entities in the group are drawn up to different reporting dates, which in any case should not be more than three months, adjustments should be made for the effects of significant transactions or other events that occur between the dates and the date of the parent's financial statements.

Further, in business combinations, there are several terminology that are important for the purposes of consolidation. In this sub-section, the following terms are further discussed (i) identifying the acquirer; (ii) date of acquisition; and (iii) costs of acquisition

1.3.1 Identifying the Acquirer (Parent)

MFRS 3 provides that the acquirer in a business combination is the combining entity that obtains control of the other combining entities (paragraph 17).

In a business combination that is effected through payment of cash, the entity that pays for the shares will ultimately gain control of the combining entities and is therefore the acquirer.

In a business combination that is effected through an exchange of equity interest, the entity that issues the equity interests is normally the acquirer. However, MFRS 3 requires that all pertinent facts and circumstances be considered to determine which of the combining entities ultimately gains control of the combining entities (paragraph 21).

In some business combinations, commonly referred to as "reversed acquisitions" (or "reverse take-overs"), the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. This often happens where a large non-listed company arranges to have itself acquired by a small listed company as a means of obtaining stock exchange listing (often referred to as "back-door listing"). In these cases, although legally the issuing listed company is the parent and the non-listed company is the subsidiary, the non-listed company (the legal subsidiary) is, in substance, the parent since it is the one who ultimately gains control over the combining entities, and consolidated financial statements have to be prepared from the non-listed company's viewpoint. For illustration on reverse acquisition, please refer to Chapter 4.

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1.3.2 Date of Acquisition

It is important, under purchase method of consolidation, to determine the date of acquisition. This is because, under purchase method, an acquirer will have to (a) incorporate into consolidated profit and loss account the results of operations of the acquiree as from the acquisition date, and (b) measure the assets and liabilities acquired based on their respective fair value as at the acquisition date. Further, where the business combination takes place near the accounting year-end, the determination of the acquisition date will affect the answer to the question of whether or not consolidated financial statements have to be presented for that accounting year.

MFRS 3 defines the date of acquisition as the date on which the acquirer obtains control of the acquiree (paragraph 8).

MFRS 3 further provides that it is not necessary for a transaction to be closed or finalised before the acquirer obtains control. All pertinent facts and circumstances surrounding a business combination should be considered in assessing when the acquirer has obtained control (paragraph 9).

1.3.3 Costs of Acquisition

MFRS 3 defined the cost of acquisition as the aggregate of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to the former owners of the acquiree, and the equity instruments issued by the acquirer (paragraph 37).

MFRS 3 further provides that cost directly attributable to the business combination (such as professional fees paid to accountants and lawyers effecting the business combination), and general administrative expenses should not be included in the cost of acquisition (paragraph 53).

To illustrate, assume A Bhd acquires B Bhd. In exchange for the shares in B Bhd, A Bhd issues 10 million of its ordinary shares (which have a market value of RM3.00 per share) and pays RM10 million cash to the former shareholders of B Bhd. A Bhd agrees to assume a liability of RM2 million payable to a supplier of B Bhd. A Bhd pays RM1 million professional fees to the accountants and lawyers for their services rendered in relation to the acquisition. A Bhd has an acquisition department, the yearly expenditure of which amounts to RM10 million, and it is estimated that approximately 30% of the staff time has been spent in relation to this acquisition. A Bhd expects to incur RM1.5 million to restructure B Bhd after the acquisition.

In this case, the cost of acquisition is calculated as equal to RM42 million (Fair value of shares issued of RM30 million + Cash of RM10 million + Liability assumed of RM2 million).

Where the business combination agreement provides for a contingent consideration arrangement, MFRS 3 requires the acquisition-date fair value of the contingent consideration to be treated as part of the cost of acquisition (paragraph 39). Further, MFRS 3 provides that subsequent changes in the fair value of the contingent consideration should be accounted for as an adjustment to the cost of acquisition if the following two conditions are met: (i) the change is made as a consequence of new information about condition existing at acquisition date and (ii) the change is made within the measurement period (not exceeding one year). If any one (or both) of the conditions is not met, the subsequent changes in the fair value of the contingent consideration will be brought to income statement (paragraph 58).

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To illustrate, assume that A Bhd acquires B Bhd, and the consideration comprises (i) an immediate payment of RM100 million, and (ii) a further payment of RM5 million after one year if the profit after tax of B Bhd for the following year exceeds RM10 million.

The payment conditional upon reaching profit target is a contingent consideration. Assume that, at the date of acquisition, it is estimated that there is a 40% chance that the profit after tax of B Bhd for the following year will exceed RM10 million, the fair value of the contingent consideration is therefore estimated to be RM2 million (40% × RM5 million). In this case, the cost of acquisition will initially be recorded at RM102 million (Dr Cost of investment RM102 million, Cr Cash RM100 million, Cr Provision for contingent payment RM2 million).

Subsequently, if the profit target is not met, and no payment is made, the provision account will be reversed and accounted for as a gain in the Income statement. If the profit target is met and A Bhd has to pay RM5 million, the additional RM3 million paid will be accounted for as a loss in the Income statement.

However, if it was discovered, during the measurement period, that B Bhd has some sales orders existed on the acquisition date which were not taken into account in estimating the probability of meeting the profit target, and that after taking into consideration these sales orders, the probability that the profit after tax of B Bhd for the following year will exceed RM10 million is 60%, and consequently the fair value of the contingent consideration is RM3 million (60% × RM5 million). In this case, because both the conditions are met, the change to the fair value of the contingent consideration of RM1 million will be adjusted against the Cost of investment.

1.4 USEFULNESS AND LIMITATIONS OF CONSOLIDATED FINANCIAL STATEMENTS

There are obvious demands for consolidated financial statements. Investors who are investing in the shares of the parent company would also want to know how the other companies in the group are performing, and would therefore be interested in the consolidated financial statements, instead of just the parent company's financial statements. Lenders who lend money to one company in a group would want corporate guarantee from the other companies in the group and would therefore be interested in the financial position of the group, instead of just that of the borrowing company. The usefulness of the consolidated financial statements to each stakeholder is discussed more specifically below.

The management of the parent will be most interested in consolidated financial statements, because it will be evaluated based on its management of all the resources under its control, the effect of which are reflected in the consolidated financial statements.

The current and prospective shareholders/investors of the parent will also be interested in the consolidated financial statements. Ultimately, the profitability of the parent is affected by the profitability of all the companies in the group.

The long term creditors of the parent may be interested in the consolidated financial statements in evaluating the overall financial health and profitability of the parent. While the parent and its subsidiaries are separate legal entities, the creditors have an effective indirect claim on the subsidiaries through the parent.

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The minority shareholders and the creditors of the subsidiaries may not be interested in the consolidated financial statements. The minority shareholders of subsidiary company only enjoy the profit of the company and have no interest in the profit of the group. The creditors of the subsidiary similarly have no claim against group resources, unless of course the debt is guaranteed by the parent.

In Malaysia, the tax authority will also not be interested in the consolidated financial statements. All companies, whether a member of a group or otherwise, are taxed individually.

Consolidated financial statements often represent the only means by which the activities and resources of all the entities that are under the same control can be meaningfully and conveniently be presented. However, some information is invariably lost when data sets are aggregated. Thus, consolidated financial statements may not reveal, for example, that some entities in the group are insolvent, or incurring losses.

Consolidated financial statements may not be meaningful if the entities in the group are involved in dissimilar activities. Consolidated results of such group cannot be compared with industry standards; one conglomerate cannot be compared with another. This shortcoming may, however, be overcome to certain extent by the presentation of segment information.

Consolidated financial statements may even be misleading to unsophisticated readers. For example, showing both the assets and the liabilities of all the entities in a group in the consolidated financial statements can erroneously imply that all reported assets are available to pay all reported liabilities. In fact, the parent's power and willingness to transfer the assets of the group from one entity to another for whatever purposes are often restricted to certain extent.

Consolidated financial statements are often criticised on the ground that the consolidated group is presented as if it were a single entity by ignoring legal boundaries. However, supporters of consolidated financial statements argue that the substance of the relationships and not merely their legal forms should form the basis of reporting.

1.5 APPROACHES ADOPTED IN THIS BOOK

Since one of the main thrusts of this book is to present a practical approach to consolidation, the discussion is based on the provisions of the accounting standards. (A brief discussion on the various consolidation theories and the alternative methods of consolidation is provided for in Chapter 10 of this book.)

There are various approaches to the preparation of consolidated financial statements. This book adopts the "worksheet" approach. The "worksheet" approach has the advantage of presenting the complete information in a concise and orderly manner, and because of this, it is the approach most commonly used in practice. It is hoped that, by adopting the approach that is most commonly used in practice, reader will be able to quickly adapt the material covered in this book to the real life situation in practice. It is also hoped that, having gained a good appreciation of consolidation process, readers will be able to prepare consolidated financial statements using other approaches such as the "T-account" approach and the "schedule" approach, if the need arises.

For supervisors who have to verify the consolidation work of the subordinates, an effective and efficient way is to perform independent proofs of the consolidated figures (instead of going through the consolidation adjustments). This book also illustrates how the proofs can be done.

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1.6 APPENDIX A: CONCEPT OF "CONTROL"

MFRS 10 establishes "control" as the basis for consolidation.

An entity that controls an investee is a parent, regardless of the nature of its involvement with the investee (paragraph 5).

An investor controls an investee if and only if the investor has all the following (paragraph 7):

(a) Power over the investee;

(b) Exposure, or rights, to variable returns from involvement with the investee; and

(c) The ability to use its power over the investee to affect the amount of the investor's returns.

To assess whether an investor has all the three elements of control mentioned above, it may be necessary to consider (a) the purpose and design of the investee, (b) what the relevant activities are and how decisions about those activities are made, (c) whether the rights of the investor give it the current ability to direct the relevant activities, (d) whether the investor is exposed or has rights to variable returns from involvement with the investee, and (e) whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns (paragraph B3).

1.6.1 Power

MFRS 10 provides that an investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities (paragraph 10).

The following elements in the definition of "power" in paragraph 10 should be noted:

(a) *Existing rights*: an investor may have power through existing voting rights arising from equity instruments or existing rights arising from contractual arrangements (paragraph 11); only substantive rights give rise to power, protective rights do not give rise to power (paragraph B9);

(b) *Current ability*: an investor has power if it has current ability to direct the relevant activities even if the rights have yet to be exercised (paragraph 12); the word "current" mean "at the time", thus, the investor must have the ability at the time when the relevant activities are to be directed (eg., during annual general meeting);

(c) *To direct*: an investor has power if it has current ability to direct, not just to participate in directing, the relevant activities (paragraph 14); and

(d) *Relevant activities:* relevant activities are the activities that significantly affect the investee's returns. In the event that two or more investor each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has power over the investee is the one that has the current ability to direct the activities that most significantly affect the returns of the investee (paragraph 13).

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Power arises from rights. Examples of rights that, either individually or collectively, can give investor power include but are not limited to (paragraph B15):

(a) Rights in the form of voting rights (or potential voting rights) of an investee;

(b) Rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;

(c) Rights to appointment or remove another entity that directs the relevant activities;

(d) Rights to direct the investee to enter into, or veto any changes to, transactions that are part of the relevant activities of the investee; and

(e) Other rights (such as decision making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

In assessing whether it has power over the investee, an investor should consider the purpose and design of the investee to (i) identify the relevant activities, how decision about those activities are made, and (iii) who has the current ability to direct those activities (paragraph B5).

In many cases, when an investee's purpose and design are considered, it may be clear that power (ie, rights that give the current ability to direct the relevant activities) arises from voting rights through holding of equity instrument. Thus, in many cases, the investor that holds a majority of those voting rights, in the absence of any other factors, has power over the investee (paragraph B6).

Illustrative Example 1.2

In all the following scenarios, assume that the investee's purpose and design are such that, power over the investee arises solely from voting rights through share-holdings proportionately.

Scenario I

A Bhd holds 60% of the issued share capital of B Bhd.

In this case, A Bhd has power over B Bhd.

Scenario II

L Bhd holds 60% of the issued share capital of M Bhd. M Bhd holds 60% of the issued share capital of N Bhd.

In this case, L Bhd has power over both M Bhd and N Bhd. M Bhd has power over N Bhd.

Scenario III

X Bhd holds 60% of the issued share capital of Y Bhd and 30% of the issued share capital Z Bhd, and Y Bhd holds 30% of the issued share capital of Z Bhd.

In this case, X Bhd has power over both Y Bhd and Z Bhd. Y Bhd does not have power over Z Bhd.

In some case, an investor with less than a majority of the voting rights may have rights that are sufficient to give it current ability to direct the relevant activities of the investee unilaterally (paragraph B41). This is referred to as "de factor" power in MFRS 10.

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For example, when the direction of relevant activities is determined by majority vote and an investor holds significant more voting rights than any other vote holder and the other shareholdings are widely dispersed, it may be clear that the investor has power over the investee (paragraph B43).

> *Illustrative Example 1.3*
>
> In all the following scenarios, assume that the investee's purpose and design are such that, power over the investee arises solely from voting rights through share-holdings proportionately.
>
> Scenario I
>
> C Bhd holds 48% of the issued share capital of D Bhd. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions.
>
> A few years ago, when assessing the proportion of voting rights to acquire, on the basis of the relative size of the other shareholdings, C Bhd determined that a 48% interest would be sufficient to give it power.
>
> In this case, C Bhd has power over D Bhd.
>
> Scenario II
>
> F Bhd holds 46% of the issued share capital of G Bhd. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions.
>
> Traditionally, less than 90% of the voting rights of G Bhd have been exercised at relevant shareholders' meeting.
>
> In this case, F Bhd has power over G Bhd.
>
> Scenario III
>
> H Bhd holds 40% of the issued share capital of J Bhd. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions.
>
> Traditionally, approximately 90% of the voting rights of J Bhd have been exercised at relevant shareholders' meeting.
>
> In this case, H Bhd does not have power over J Bhd.
>
> Scenario IV
>
> M Bhd holds 45% of the issued share capital of N Bhd. The remaining 55% shareholdings are held by three other shareholders in equal proportions.
>
> In this case, it only takes the three other shareholders to co-operate to be able to prevent M Bhd from directing the relevant activities of N Bhd. Thus, M Bhd does not have power over N Bhd.

As shown in the above illustration, in cases when an investor has less than majority voting rights, the determination of whether the investor has power (through voting rights) is subjective. There are no bright lines and thus significant judgement is required. MFRS 10 requires the investor to consider all facts and circumstances, including voting patterns at previous shareholders' meetings, and the size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders, noting that (i) the more voting rights an investor holds, the more likely the investors is to have power, (ii)

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the more voting rights an investor holds relative to other vote holders, the more likely the investors is to have power, and (iii) the more parties that would need to act together to outvote the investor, the more likely the investor is to have power (paragraph B42).

Where the investee has issued potential voting rights (ie, securities with the potential of being converted into ordinary shares with voting rights, for examples, options, warrant, and convertible bonds), the investor should takes these potential voting rights into consideration in determining whether it has power.

MFRS 10 provides that the potential rights should be considered only if the rights are substantive, ie, the holders must have practical ability to exercise those rights (paragraph B47). (Note that this is different from the provision of the now-superseded MFRS 27 (2010) *Consolidated and Separate Financial Statements* which required the potential voting rights to be considered in determining control as soon as they are exercisable/convertible, and regardless of holders' intention and ability to exercise/convert).

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> *Illustrative Example 1.4*
>
> In all the following scenarios, assume that the investee's purpose and design are such that, power over the investee arises solely from voting rights through share-holdings proportionately.
>
> Scenario I
>
> A Bhd holds 40%, and B Bhd holds 60% of the 100 million shares of C Bhd when C Bhd was incorporated in 20×1. On 1 January 20×5, C Bhd issues options to A Bhd to buy 50 million shares of C Bhd to be issued at RM1.00 per share.
>
> In this case, B Bhd has power over C Bhd from 20×1 to 20×4, and A Bhd has power over C Bhd in 20×5 (and subsequent years).
>
> However, if the options are deeply out-of the money in 20×5 (for example, the fair value of the shares of C Bhd is RM0.20 per share), and A Bhd will therefore not exercise the options, the potential voting rights (option) are not substantive in 20×5. In this case, B Bhd continues to have power over C Bhd in 20×5.
>
> Also, if the options are in-the-money (for example, the fair value of the shares of C Bhd is more than RM1.00 per share), but A Bhd does not have the financial resources to exercise the option, then the potential voting rights (options) are not substantive in 20×5. In this case, B Bhd continues to have power over C Bhd in 20×5.
>
> Scenario II
>
> X Bhd holds 40%, and Y Bhd holds 60%, of the 100 million shares of Z Bhd when Z Bhd was incorporated in 20×1. On 1 January 20×5, Z Bhd issues RM50 million convertible bonds to X Bhd. The bonds are convertible from 1 January 20×6 onwards into 50 million shares of C Bhd to be issued at RM1.00 per share.
>
> In this case, Y Bhd has power over Z Bhd from 20×1 to 20×5, and X Bhd has power over Z Bhd in 20×6 when the convertible bonds are convertible.
>
> However, if X Bhd does not wish to convert the convertible bonds in 20×6 because, for example, the returns from holding the convertible bonds are much higher than the returns from holding the shares, then the potential voting rights (convertible bonds) are not substantive in 20×6. In this case, Y Bhd continues to have power over Z Bhd in 20×6.

When an investee's purpose and design are considered, it may sometimes be clear that voting rights are not dominant factor in deciding who has power over the investee. For example, when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such a case, MFRS 10 requires the investor to assess the contractual arrangements in order to determine whether it has rights sufficient to give it power (paragraph B17).

Sometimes, a combination of voting rights from shareholding with other decision-making rights from contractual arrangement may give an investor power.

> ***Illustrative Example 1.5***
>
> D Bhd holds 30% of the issued share capital of E Bhd, a retailer of consumer products. There is also a contractual arrangement under which D Bhd controls the purchase of inventory and sale of goods of E Bhd. This contractual arrangement may only be rescinded with the consent of 3/4 of the total shareholders of E Bhd.
>
> In this case, D Bhd has power over E Bhd, since it has the current ability to direct the relevant activities of E Bhd (the contract cannot be rescinded without its consent).

MFRS 10 requires that, in assessing power, only substantive rights are considered, protective rights are not.

For a right to be substantive, the holder must have practical ability to exercise that right (paragraph B22) and the right has to be exercisable when decisions about the direction of the relevant activities are to be made (paragraph B24).

> ***Illustrative Example 1.6***
>
> Scenario I
>
> H Bhd holds 60% of the issued share capital of J Bhd. The purpose and design of J td are such that power over J Bhd arises solely from voting rights through share-holdings proportionately.
>
> In this case, H Bhd has power over J Bhd.
>
> Scenario II
>
> K Bhd holds 60% of the issued share capital of L Bhd when L Bhd is incorporated in 20×1. The purpose and design of L td are such that power over L Bhd arises solely from voting rights through share-holdings proportionately.
>
> In 20×5, L Bhd is placed under judicial management, and the judicial manage has the sole right to direct the relevant activities of L Bhd.
>
> In this case, K Bhd has power over L Bhd from 20×1 to 20×4, but it does not have power over L Bhd in 20×5.
>
> Scenario III
>
> M Bhd holds 60% of the issued share capital of N Bhd, which is incorporated by the government to manufacture equipment for national security. The government, which holds only one share in N Bhd, has absolute control over the operations of N Bhd.
>
> In this case, M Bhd does not have power over N Bhd.

Protective rights are designed to protect the interests of their holder without giving that party power over the investee. Thus, an investor that holds only protective rights does not have power over an investee.

> ***Illustrative Example 1.7***
>
> Scenario I
>
> S Bhd is a manufacturer of consumer products, and borrows a loan from T Bank Bhd. Under the loan agreement, T Bank Bhd has a right to seize the land, the factory and the manufacturing machinery of S Bhd in the event that S Bhd defaults on its loan repayment.
>
> In this case, T Bank Bhd's right is protective right, and therefore T Bank Bhd has no power over S Bhd.
>
> Scenario II
>
> AAA Bhd sets up and subsequently manages the FF Fund. AAA Bhd determines the investment policy and strategy for the FF Fund. AAA Bhd receives a market-based management fee of 2% of the market value of the net assets in FF Fund.
>
> There are 30 investors in FF Fund. BBB Bhd owns 60% of the shares in the FF Fund, and the rest of the shares in FF Fund are distributed among the other 29 investors. The rights held by the investors are protective in nature. The investors cannot unilaterally change the investment policy and strategy of FF Fund, cannot be remove the fund manager AAA Bhd without cause.
>
> In this case, BBB Bhd has a majority of the voting rights in FF Fund. However, these rights are protective in nature and do not give BBB Bhd the ability to direct the relevant activities of FF Fund. Thus, BBB Bhd has no power over FF Fund.
>
> Scenario III
>
> X Bhd operates a business under a franchise agreement with Y Bhd, the franchisor.
>
> The franchise agreement merely gives the franchisor rights that are designed to protect the franchise brand. The franchise agreement does not restrict the ability of the franchisee or other parties to have current ability to direct the relevant activities of the franchisee.
>
> Thus, in this case, Y Bhd does not have power over X Bhd.

MFRS 10 provides that mere economic dependency does not give rise to power (paragraph B40).

> ***Illustrative Example 1.8***
>
> P Bhd is a manufacturer of consumer products. P Bhd purchases 80% of its raw materials from Q Bhd, and sell 60% of its finished products to R Bhd.
>
> In this case, neither Q Bhd nor R Bhd has power over P Bhd.

MFRS 10 provides, if it is not clear, having considered all the above issues, that the investor has power, then it should be concluded that the investor does not control the investee (paragraph B46).

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1.6.2 Returns

An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance (paragraph 15).

Exposure or having rights to variable returns is a necessary but not a sufficient condition for an investor to have control over the investee. An investor (eg non-controlling interest) could be exposed or has right to variable returns, but does not have control over the investee. However, an investor must be exposed or has rights to variable returns in order to have control over the investee. An investor that is not exposed or has no rights to variable returns may probably be acting as an agent and has no control over the investee.

An investor's investment in ordinary shares of an investee will definitely result in investor being exposed or having rights to variable returns, as the dividends received and the fair value of the shares held depends largely on the investee's performance.

However, MFRS 10 also takes the view that an investor's investment in fixed rate bond of an investee will also result in investor being exposed or having rights to variable returns, as the interest and principle payments are subject to the credit risks of the investee. Similarly, fixed performance fee for managing an investee's assets is also variable returns because it is exposed to the performance risk of the investee in that it depends on the investee's ability to generate sufficient income to pay the fee (paragraph B56).

1.6.3 Link between Power and Returns

An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use the power to affect the investor's returns from its involvement in the investee (paragraph 17).

In most cases, it can be clearly and easily demonstrated that an investor's majority shareholding in an investee will give the investor the ability to use the power to affect its returns from its involvement in the investee.

Illustrative Example 1.9

In all the following scenarios, assume that the investee's purpose and design are such that, power over the investee arises solely from voting rights through share-holdings proportionately.

Scenario I

A Bhd holds 60% of the issued share capital of B Bhd.

In this case, A Bhd's 60% shareholding in B Bhd will (a) give A Bhd power over B Bhd, (b) expose A Bhd to variable returns, and (c) give A Bhd the ability to use its voting rights to affect its returns from B Bhd.

Thus, A Bhd controls B Bhd.

Scenario II

C Bhd holds 10% of the issued share capital of D Bhd.

In this case, C Bhd's 10% shareholding in D Bhd will not give C Bhd power over D Bhd, and also will not give C Bhd the ability to use its voting rights to affect its returns from D Bhd.

Thus, C Bhd does not control D Bhd.

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Scenario III

L Bhd holds 60% of the issued share capital of M Bhd. M Bhd holds 60% of the issued share capital of N Bhd.

In this case, L Bhd's 60% shareholding in M Bhd and M Bhd's 60% shareholding in N Bhd will (a) give L Bhd power over N Bhd, (b) expose L Bhd to variable returns from N Bhd (because L Bhd is exposed to variable returns from M Bhd, and M Bhd is exposed to variable returns from N Bhd), and (c) give L Bhd the ability to use its voting rights to affect its returns from N Bhd (through M Bhd).

Thus, L Bhd not only controls M Bhd but also controls N Bhd, and M controls N Bhd.

Scenario IV

X Bhd holds 60% of the issued share capital of Y Bhd and 30% of the issued share capital Z Bhd, and Y Bhd holds 30% of the issued share capital of Z Bhd.

In this case, X Bhd's direct shareholding of 30% in Z Bhd and its indirect shareholding of 30% (through Y Bhd) will (a) give X Bhd power over Z Bhd, (b) expose X Bhd to variable returns from Z Bhd, and (c) give X Bhd the ability to use its voting rights to affect its returns from Z Bhd.

Thus, X Bhd controls both Y Bhd and Z Bhd.

However, Y Bhd's 30% shareholding in Z Bhd will not give Y Bhd power over Z Bhd, and also will not give Y Bhd the ability to use its voting rights to affect its returns from Z Bhd.

Thus, Y Bhd does not control Z Bhd.

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In cases where decision-making rights have been delegated or are being held for the benefits of others, it is more difficult to assess whether the decision maker has the ability to use its power to affect the its returns from the other entity.

In such cases, it is necessary to assess whether the decision maker is a principal or an agent. Thus, MFRS 10 provides that an investor with decision-making rights should determine whether it is a principal or an agent (paragraph 18).

An investor acting as principal has the ability to use the power to affect the investor's returns from its involvement in the investee, but an investor acting as an agent does not have the ability to use the power to affect the investor's returns from its involvement in the investee (paragraph B58).

An agent is a party primarily engaged to act on behalf and for the benefit of another party (the principal) and therefore does not control the investee.

MFRS 10 further provides that a decision maker, in determining whether it is a principal or an agent, should consider the overall relationship between itself, the investee, and other parties, and in particular all the factors below (paragraph B60):

(a) The scope of its decision-making authority;

(b) The rights held by other parties;

(c) Its remuneration; and

(d) Its exposure to variability of returns through other interests.

Firstly, for a decision-maker to control the entity over which it has been delegated decision-making authority, the decision maker must have power that gives it current ability to direct the relevant activities of the entity. If the decision maker is delegated decision-making rights that do not relate to relevant activities, the decision maker does not have control. Thus, it is important to consider the scope of the decision-making authority.

In considering the scope of its decision-making authority over the investee, the decision maker should consider the purpose and design of the investee, the risk to which the investee was designed to be exposed, the risk it was designed to pass on to the parties involved, and the level of involvement the decision maker has in the design of an investee (paragraph B63).

> ***Illustrative Example 1.10***
>
> ABC Bhd establishes and manages a special purpose vehicle, BCD Company.
>
> In this case, ABC Bhd is significantly involved in the design of BCD Company. This involvement may indicate that ABC Bhd had the opportunity and incentive to obtain rights that result in ABC Bhd having the ability to direct the relevant activities.
>
> Thus, ABC Bhd is acting as a principal.

Secondly, rights held by other parties may affect the decision maker's ability to direct the relevant activities of the investee (paragraph B64).

When a single party holds substantive right to remove the decision maker without cause, this, in isolation, is sufficient to conclude that the decision maker is an agent. If more than one party holds such rights, those rights are not, in isolation, conclusive in determining whether the decision maker acts as a principal or as an agent. The greater the number of parties required to act together to exercise rights to remove the decision maker, the less the weightage should be placed on this factor in determining whether the decision maker acts as a principal or as an agent (paragraph B65).

> ***Illustrative Example 1.11***
>
> MMM Management Company manages an investment fund, FFF Fund. BBB Bhd holds 30% of the investments in FFF Fund, and the rest of the investment are held by other investors, each holding less than 1%.
>
> Scenario I
>
> BBB Bhd has the right to change the fund manager of FFF Fund at its own discretion.
>
> In this case, it can be concluded that MMM Management Company is acting as an agent, and therefore does not control FFF Fund.
>
> Scenario II
>
> MMM Management Company can only be removed as the fund manager of FFF Fund by majority of the voting rights during the Fund's annual general meeting.
>
> In this case, based on the rights held by other parties, it is not determinable whether MMM Management Company is acting as a principal or as an agent.

Thirdly, as for remuneration, the greater the magnitude of, and variability associated with, the decision maker's remuneration relative to the returns expected from the activities of the investee, the more likely the decision maker is a principal (paragraph B68).

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On the other hand, if (a) the remuneration of the decision maker is commensurate with the service provided, and (b) the remuneration agreement includes only terms, conditions or amounts that are negotiated at arm's length basis, it is more likely that the decision maker is an agent (paragraph B69).

> ***Illustrative Example 1.12***
>
> LM Bhd manages the day-to-day operations of NN Bhd, a special purpose vehicle set up by PQ Bhd.
>
> Scenario I
>
> Assume that LM Bhd's management fee is calculated as equal to 60% of NN Bhd's profit after tax figure.
>
> In this case, it is likely that LM Bhd is acting as a principal.
>
> Scenario II
>
> Assume that LM Bhd's management fee is RM100,000 per month, fixed in accordance with the prevailing market rate.
>
> In this case, it is likely that LM Bhd is acting as an agent and therefore does not control NN Bhd.

Fourthly, a decision maker that holds other interests in an investee (for example, investment in investee, or providing guarantee to investee's bank borrowing) should consider its exposure to variability of returns from those interests (paragraph B71).

Generally, the greater the magnitude of, and variability associated with, the decision maker's economic interests in relation to its remuneration, the more likely the decision maker is a principal.

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> ***Illustrative Example 1.13***
>
> FM Bhd establishes and manages an investment fund, FF Fund. As the fund manager, FM Bhd has wide decision-making discretion to make decisions in the best interests of all the investors. FM Bhd receives a market-based fee for its service equal to 2% of the cost of the fund plus 10% of the fund's profit.
>
> Scenario I
>
> Assume that FM Bhd does not have other interest in FF Fund.
>
> In this case, although FM Bhd has decision-making rights that give it the current ability to direct the relevant activities of FF Fund, it receives a market-based fee for its service that is commensurate with the service provided which does not create an exposure that is of such significance that it indicates it is a principle. Thus, it may be concluded that FM Bhd is acting as an agent and therefore does not control FF Fund.
>
> Scenario II
>
> Assume that FM Bhd, in the above case, holds 30% of the investment in FF Fund.
>
> In this case, the 30% shareholding in the FF Fund exposes FM Bhd and gives it rights to variability in returns. Thus, it may be determined that FM Bhd is acting as a principal.
>
> Further, it is clear that FM Bhd has decision-making rights that give it the current ability to direct the relevant activities of FF Fund, it is exposed and has right to variability in returns, and it has the ability to use the power to affect its returns from its involvement in FF Fund.
>
> Thus, it may be concluded that, in this case, FM Bhd controls FF Fund.

As mentioned earlier, MFRS 10 provides that a decision maker, in determining whether it is a principal or an agent, should consider the overall relationship between itself, the investee, and other parties, and in particular all the four factors listed in paragraph B60 (namely, the scope of its decision-making authority, the rights held by other parties, its remuneration, and its exposure to variability of returns through other interests).

Illustrative Example 1.14

Refer to the case in Illustrative example 1.13 above, where FM Bhd establishes and manages an investment fund, FF Fund. As the fund manager, FM Bhd has wide decision-making discretion to make decisions in the best interests of all the investors, and receives a market-based fee for its service equal to 2% of the cost of the fund plus 10% of the fund's profit. FM Bhd also holds 30% of the investment in FF Fund.

Assume further that FF Fund has a board of directors appointed by the investors other than FM Bhd, and the board of directors has the power to appoint the fund manager for the FF Fund during the annual general meeting of the fund.

In this case, FM Bhd has decision-making rights that give it the current ability to direct the relevant activities of FF Fund, and is exposed and has right to variability in returns. However, the fact that other investors have substantive rights to remove fund manager indicates that FM Bhd is acting as an agent. Consequently, FM Bhd does not have the ability to use its power to affect its returns from its involvement in FF Fund.

Thus, it may be concluded that, in this case, FM Bhd does not control FF Fund.

1.6.4 Other Considerations

In determining control, MFRS 10 also requires/deals with the following:

(a) Related parties and *de factor* agents;

(b) Control of specific assets (silo); and

(c) Continuous assessment.

Related parties and de factor agents

When assessing control, an investor should consider the nature of its relationship with other parties. In cases where those other parties are acting on the investor's behalf (ie. ''de facto agents''), MFRS 10 requires the investor to consider its de facto agent's power, variable return and ability to use the power to influence the variable returns (ie. the 3 elements of control) together with its own in assessing control of an investee (paragraph B74).

Illustrative Example 1.15

M Bhd holds 40% and N Bhd holds 20% of the issued share capital of L Bhd when L Bhd was incorporated in 20×1 in a foreign country. The purpose and design of L Bhd are such that, power over L Bhd arises solely from voting rights through share-holdings proportionately.

N Bhd holds the 20% shareholding in L Bhd, largely on M Bhd's behalf, in order to avoid breaching the regulation in the foreign country that forbids more than 50% shareholding by a single company.

In this case, N Bhd is a de facto agent of M Bhd. When assessing control over L Bhd, M Bhd should take into consideration N Bhd's 20% shareholding together with its own 40% shareholding, as required by MFRS 10.

Control of specific assets (silo)

MFRS 10 requires that an investor should consider whether it treats a portion of an investee as a deemed separate entity (ie ''silo''), and if so, whether it controls the deemed separate entity (paragraph B76).

If the investor controls the deemed separate entity, MFRS 10 provides that the investor should consolidate that portion of the investee, and other parties exclude that portion of the investee when assessing control of (and in consolidation), the investee (paragraph B79).

Identifying whether a silo exists, and whether an investor controls a silo, can be complex.

MFRS 10 provides that an investor should treat a portion of an investee as a deemed separate entity (silo) if and only if the following condition is satisfied (paragraph B77): specified assets of the investee are the only source of payment for specified liabilities, and parties other than those with specified liabilities do not have rights related to the specified assets. Thus, in substance, the assets and liabilities of that deemed separate entity are ring-fenced from the overall investee.

If a silo exists, the next step is to identify the relevant activities of the silo and who has current ability to direct those activities. The party that has power should further consider whether it is exposed or has right to variable returns from the silo, and whether it has the ability to use its power to affect its returns from its involvement in the silo.

If an investor concludes that it controls a silo, it consolidates the silo (not the entire host entity). If an investor concludes that it controls the host entity, but not the silo within the host entity, it consolidates the host entity excluding the silo.

Illustrative Example 1.16

ABC Bhd is a special purpose vehicle holding three office buildings and one factory building.

The three office buildings are leased to various parties, each lessee holds a debt instrument issued by ABC Bhd amounting to 50% of the value of the office building leased.

The factory has value of RM10 million, and is leased to XYZ Bhd. XYZ Bhd holds a debt instrument of RM10 million issued by ABC Bhd. The debt instrument is secured on the factory, but does not have recourse to other assets of ABC Bhd. XYZ Bhd also has a fixed price purchase option to purchase the factory for RM10 million.

In this case, no silo exists for the office buildings, but a silo exists for the factory building.

Continuous assessment

MFRS 10 provides that, if facts and circumstances indicate that there are changes to one or more of the 3 elements of control discussed above, an investor should reassess whether it controls an investee (paragraph B80).

Illustrative Example 1.17

A Bhd holds 60% of the issued share capital of B Bhd when B Bhd was incorporated in 20×1. The purpose and design of B Bhd are such that, power over B Bhd arises solely from voting rights through share-holdings proportionately.

Assume that in 20×5, the management of B Bhd is entrusted to a management company C Bhd through a contract.

In this case, it is obvious that A Bhd controls B Bhd from 20×1 to 20×4. However, in 20×5, A Bhd has to reassess whether it still controls B Bhd.

It is possible, in this case, that from 20×5, the relevant activities of B Bhd may no longer be directed through voting rights, but instead the contract arrangement may give C Bhd the current ability to direct the relevant activities of B Bhd.

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Another issues is the apportionment of the reserves of the subsidiary into "pre-acquisition reserves" (the portion that existed before the subsidiary was acquired) and "post-acquisition reserves" (the portion that arose after the subsidiary was acquired). The significance of the apportionment and the consolidation treatment of pre-acquisition reserves and post-acquisition reserves are discussed in section 3.3.

Subsequent to the date of acquisition, there could be transactions between the companies in the group. This gives rise to several problems in consolidation. These problems will be discussed in sections 3.4, 3.5 and 3.6.

Finally, the goodwill on consolidation capitalised at the date of acquisition will have to be subjected to impairment tests annually in the subsequent periods. Also, if depreciable assets of the subsidiary are deemed to be undervalued or overvalued, then consolidation adjustment may have to be made to the depreciation charges in the subsequent periods. These two consolidation issues will be discussed in section 3.7.

3.2 CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Subsequent to the date of acquisition, the parent and the subsidiary will operate as a group, and therefore consolidated statement of comprehensive income, together with the consolidated balance sheet, will have to be prepared for each of the subsequent accounting periods. (Consolidated statement of comprehensive income may also be prepared in isolation for certain specific purposes, for example, for the determination of half-yearly group profits).

Assuming that there are no fair value adjustments and no intragroup transactions, the preparation of consolidated statement of comprehensive income will be a simple task of just adding together, line by line, all the items in the individual statement of comprehensive incomes of the parent and subsidiary.

If the parent acquires less than 100% of the subsidiary's issued share capital, part of the subsidiary's "profit after tax" and "total comprehensive income" is attributable to the non-controlling shareholders. Theoretically, what could be done, is to add say 80% of subsidiary's statement of comprehensive income items (assuming parent acquires 80% of subsidiary's issued share capital) to the statement of comprehensive income items of the parent to arrive at the "group profit after tax" and "group total comprehensive income" in the consolidated statement of comprehensive income. However, MFRS 10 requires the application of the "full consolidation" principle and that non-controlling interest in the profit after tax and total comprehensive income of the group are to be separately disclosed (paragraph 33). Thus, in practice and in accordance with the requirements of the accounting standard, 100% of the subsidiary's statement of comprehensive income items (even though parent acquires less than 100% of subsidiary's issued share capital) are added to those of the parent to arrive at total profit after tax and total comprehensive income. The total profit after tax and total comprehensive income are then apportioned into amounts attributable to the shareholders of the parent and the amounts attributable to non-controlling interest. The apportionment can be done quite easily by first determining the amount attributable to the non-controlling interest, and the balance will be the amount attributable to the shareholders of the parent.

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The amount of total profit after tax attributable to non-controlling interest is calculated based on non-controlling interest in the subsidiary's "profit after tax". The amount of total comprehensive income attributable to non-controlling interest is calculated as the sum of (i) non-controlling interest in the subsidiary's "profit after tax" and (ii) non-controlling interest in the subsidiary's "other comprehensive income".

Illustrative Example 3.1

Y Bhd acquired 60% of the issued share capital of Z Bhd on 31 December 20X7. There are no intragroup transactions. The statements of comprehensive income of Y Bhd and Z Bhd for the year ended 31 December 20X8 are as follows:

	Y Bhd	*Z Bhd*
	RM'000	*RM'000*
Sales	100	80
Cost of sales	30	20
Gross profit	70	60
Operating expenses	20	30
Profit before tax	50	30
Tax	15	10
Profit after tax	35	20
Other comprehensive income		
Fair value gain	10	10
Revaluation surplus	50	20
Total	60	30
Total comprehensive income	95	50

Required: Prepare the consolidated statement of comprehensive income for Y Bhd and its subsidiary for the year ended 31 December 20X8.

Solution:

(I) Calculation of non-controlling interest (NCI)

NCI in profit after tax
= non-controlling interest × subsidiary's profit after tax
= 40% × RM20,000
= RM8,000

NCI in fair value gain
= non-controlling interest × subsidiary's fair value gain
= 40% × (RM10,000)
= RM4,000

NCI in revaluation surplus
= non-controlling interest × subsidiary's revaluation surplus
= 40% × (RM20,000)
= RM8,000

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NCI in total comprehensive income
= RM8,000 + RM4,000 + RM8,000
= RM20,000

(II) Consolidation journal entries

(a)	Dr Non-controlling interest - profit	8	
	Cr Non-controlling interest (CBS)		8
	(non-controlling interest in subsidiary's profit after tax)		
(b)	Dr Non-controlling interest - fair value gain	4	
	Dr Non-controlling interest - revaluation surplus	8	
	Cr Non-controlling interest (CBS)		12
	(non-controlling interest in subsidiary's other comprehensive income)		

(III) Consolidation worksheet

	Y Bhd	*Z Bhd*	*Adjustments*			*Consolidated Balances*
			Dr		*Cr*	
	RM'000	*RM'000*	*RM'000*		*RM'000*	*RM'000*
Sales	100	80				180
Cost of sales	30	20				50
Gross profit	70	60				130
Operating expenses	20	30				50
Profit before tax	50	30				80
Tax	15	10				25
Profit after tax	35	20				55
NCI	–	–	a	8		8
Group profit	–	–				47
Fair value gain	10	10				20
NCI	–	–	b	4		4
Group fair value gain						16
Revaluation surplus	50	20				70
NCI	–	–	b	8		8
Group reval surplus	–	–				62
Group comp income	95	50				125

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(IV) Consolidated statement of comprehensive income

Y Bhd and its subsidiary
Consolidated statement of comprehensive income
For the year ended 31 December 20X8

	RM'000
Sales	180
Cost of sales	50
Gross profit	130
Operating expenses	50
Profit before tax	80
Tax	25
Profit after tax	55
Other comprehensive income	
Fair value gain	20
Revaluation surplus	70
Total	90
Total comprehensive income	145
Profit after tax attributable to:	
Shareholders of the parent	47
Non-controlling interest	8
	55
Total comprehensive income attributable to:	
Shareholders of the parent	125
Non-controlling interest	20
	145

Notes to the solution:

(a) The debit entry in the first consolidation journal entry (CJE) is to record non-controlling interest in the subsidiary's after-tax profit.

(b) The debit entries in the second CJE is to record non-controlling interest in the subsidiary's other comprehensive income.

(c) Combining the debit entries of the first and second CJE will yield the non-controlling interest in the subsidiary's total comprehensive income.

(d) The non-controlling interest in the after-tax profit will be presented in the consolidated statement of comprehensive income as a deduction from the total after-tax profit so as to arrive at the profit attributable to the shareholders of the parent.

(e) The non-controlling interest in the total comprehensive income will be presented in the consolidated statement of comprehensive income as a deduction from the total comprehensive income so as to arrive at the total comprehensive income attributable to the shareholders of the parent.

(f) The credit entries of the two CJE are to record non-controlling interest in the subsidiary's total comprehensive income (which forms part of subsidiary's shareholders' equity) to be presented in the consolidated balance sheet. (These two credit entries only records non-controlling interest in the subsidiary's total comprehensive income for the year. Therefore other CJE(s) will be necessary to record

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non-controlling interest in the subsidiary's shareholders' equity other than the total comprehensive income for the year, so as to present a complete picture of non-controlling interest in the subsidiary's net assets in the consolidated balance sheet. These other CJE(s) will be illustrated in subsequent sections.)

(g) Note that 100% of Z Bhd's statement of comprehensive income items are added, line by line, to those of Y Bhd, in accordance with the full consolidation principle of MFRS 10.

(h) Note that in the "consolidated balances" column of the consolidation worksheet, sub-total figures (for examples, "Profit before tax", "Profit after tax" and "Total comprehensive income") are obtained by adding or subtracting downwards along the column, unlike the other figures which are obtained by adding across, line by line. Note also that no consolidation adjustments are made to the sub-total figures.

(i) The group profit ("Profit attributable to shareholders of the parent") of RM47,000 may be proved as follow: Parent's after-tax profit of RM35,000 plus the parent's 60% share of the subsidiary's after-tax profit of RM12,000 (60% × RM20,000).

(j) The group total comprehensive income ("Total comprehensive income attributable to shareholders of the parent") of RM125,000 may be proved as follow: Parent's total comprehensive income of RM95,000 plus the parent's 60% share of the subsidiary's total comprehensive income of RM30,000 (60% × RM50,000).

If a subsidiary incurs a loss, non-controlling interest will be allocated its share of the loss (and the consolidated journal entry will be Dr Non-controlling interest (CBS) and Cr Non-controlling interest (CSCI)). MFRS 10 provides that this is also applicable to situation where the loss suffered by the subsidiary exceeds its shareholders' equity (paragraph B94).

FRS 127 (2010), which was effective on 1 July 2010 and is now superseded by MFRS 10, also required the same treatment. However, prior to FRS 127 (2010), the accounting standards required the amount of loss allocated to non-controlling interest to be limited to its share of the equity of the subsidiary, so that non-controlling interest would not be carried with a debit balance in the consolidated balance sheet.

Thus, the requirement that non-controlling interest should be allocated its share of loss even if this results in the non-controlling interest having a deficit balance (under FRS 127 (2010) and MFRS 10) is effective prospectively for annual periods commencing on or after 1 July 2010.

To illustrate, assume that P Bhd acquires 90% of S Bhd on 31 December 20X5 when S Bhd's net assets are represented by share capital of RM100,000 and retained profit of RM50,000. S Bhd suffers a loss of RM200,000 for the year ended 31 December 20X6. In this case, non-controlling interest in 20X5 consolidated balance sheet will be carried at RM15,000 (10% × RM150,000). In the 20X6 consolidated financial statements: (a) applying the rules under the old accounting standards prior to 1 July 2010, the amount of 20X6 loss allocated to non-controlling interest will be limited to RM15,000 (and not RM20,000 (10% × RM200,000)); consequently, non-controlling interest will be reported at RM15,000 (loss) in the consolidated statement of comprehensive income, and carried at zero balance in the consolidated balance sheet, (b) applying the rules under FRS 127 (2010) and MFRS 10, the amount of 20X6 loss allocated to non-controlling interest will be RM20,000 (10% × RM200,000)); consequently, non-controlling interest will be reported at RM20,000 (loss) in the consolidated statement of comprehensive income, and reported with a debit balance of RM5,000 in the consolidated balance sheet.

As mentioned above, this change in accounting treatment is effective prospectively for annual periods commencing on or after 1 July 2010.

For further discussions and illustrations for loss-making subsidiary, please refer to Chapter 4 (section 4.3.2).

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3.3 PRE-ACQUISITION AND POST-ACQUISITION RESERVES

At a date subsequent to the date of acquisition, the subsidiary's reserves can be categorised into two parts: those that arose before the subsidiary was acquired and those that arose after subsidiary was acquired. The former is called "pre-acquisition reserves" and the latter "post-acquisition reserves".

It is important to make the distinction, because pre-acquisition reserves represent the net assets of the subsidiary at the date of acquisition and therefore has to be eliminated against the cost of investment in the consolidation process (also, pre-acquisition reserves are not earned under the common control and therefore should not be shown in the consolidated financial statements); whereas post-acquisition reserves represent reserves earned by the subsidiary after it became a member of the group and therefore form part of the reserves of the group and consequently has to be included in the consolidated financial statements.

Illustrative Example 3.2

Refer to the case in Illustrative example 2.1 in chapter 2, where A Bhd acquired 100% of the issued share capital of B Bhd on 31 December 20X8 for a total consideration of RM120,000. At that date, B Bhd's net assets at fair value was represented by share capital of RM100,000 and retained profit of RM20,000. Assume the balance sheets of A Bhd and B Bhd as at 31 December 20X9 (1 year after the date of acquisition) are as follows:

	A Bhd	*B Bhd*
	RM'000	*RM'000*
Land	400	150
Investment in B Bhd	120	–
Debtors	230	50
Bank	50	30
	800	230
Share capital	500	100
Retained profit	200	50
Long term loan	–	50
Creditors	100	30
	800	230

Required: Prepare the consolidated balance sheet for A Bhd and its subsidiary as at 31 December 20X9.

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Solution:

(I) Consolidation journal entry

Dr Share capital (B)	100	
Dr Retained profit (B)	20	
Cr Investment in B		120
(elimination of Investment account)		

(II) Consolidation worksheet

	A Bhd	*B Bhd*	*Adjustments Dr*	*Adjustments Cr*	*Consolidated Balances*
	RM'000	*RM'000*	*RM'000*	*RM'000*	*RM'000*
Land	400	150			550
Investment	120	–		120	–
Debtors	230	50			280
Bank	50	30			80
Share capital	500	100	100		500
Retained profit	200	50	20		230
Long term loan	–	50			50
Creditors	100	30			130

(III) Consolidated balance sheet

A Bhd and its subsidiary
Consolidated balance sheet
As at 31 December 20X9

	RM'000
Land	550
Debtors	280
Bank	80
	910
Share capital	500
Retained profit	230
Long term loan	50
Creditors	130
	910

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Notes to the solution:

(1) The retained profit of B Bhd of RM50,000 at 31 December 20X9 can be apportioned into pre-acquisition of RM20,000 (the amount of retained profit as at 31 December 20X8, the date of acquisition) and post-acquisition of RM30,000 (the amount earned after 31 December 20X8). The pre-acquisition retained profit of RM20,000 is eliminated in the consolidation journal entry, whereas the post-acquisition retained profit of RM30,000 is added to the group's retained profit.

(2) The consolidation journal entry to eliminate investment account (as that made in 20X8) has to be made again in 20X9 consolidation. This is because (i) consolidation journal entries are made for the purpose of consolidation only and not recorded in the books of the companies of the group, and (ii) consolidation financial statements for a year are prepared from the entity financial statements of the companies of the group for that year and not from the consolidated financial statements of the previous year. Thus the same consolidation journal entry to eliminate investment account has to be made every year the consolidated financial statements are prepared for the group. (This type of consolidation adjustments are commonly referred to in practice as ''permanent adjustments''.)

It should be noted, however, that the apportionment of subsidiary's reserves into pre-acquisition and post-acquisition is important as regard the parent only. It is of no relevance to the non-controlling shareholders. As far as the non-controlling shareholders are concerned, they have been there all the time, there is no ''date of acquisition'' and therefore, there is no distinction between pre-acquisition and post-acquisition reserves. Non-controlling interest in the consolidated balance sheet is always equal to the non-controlling shareholding percentage multiplied by the fair value of the net identifiable assets of the subsidiary as at the balance sheet date.

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Illustrative Example 3.3

M Bhd acquired 90% of the issued share capital of N Bhd on 31 December 20X8 for a total consideration of RM108,000. At that date, N Bhd's net assets at fair value was represented by share capital of RM100,000 and retained profit of RM20,000. The balance sheets of M Bhd and N Bhd as at 31 December 20X9 (1 year after the date of acquisition) are as follow:

	M Bhd	*N Bhd*
	RM'000	*RM'000*
Land	400	150
Investment in N Bhd	108	–
Debtors	200	–
Bank	92	30
	800	180
Share capital	500	100
Retained profit	200	30
Long term loan	–	50
Creditors	100	–
	800	180

Required: Prepare the consolidated balance sheet for M Bhd and its subsidiary as at 31 December 20X9.

Solution:

(I) Consolidation journal entries

(a)	Dr Share capital (N)	90		(90% × 100)
	Dr Retained profit (N)	18		(90% × 20)
	Cr Investment in N		108	
	(elimination of Investment account)			
(b)	Dr Share capital (N)	10		(10% × 100)
	Dr Retained profit (N)	3		(10% × 30)
	Cr Non-controlling interest		13	
	(to record non-controlling interest)			

(II) Consolidation worksheet

	M Bhd	*N Bhd*	*Adjustments*				*Consolidated Balances*
				Dr		*Cr*	
	RM'000	*RM'000*		*RM'000*		*RM'000*	*RM'000*
Land	400	150					550
Investment	108	–			a	108	–
Debtors	200	–					200
Bank	92	30					122
Share capital	500	100	a	90			500
			b	10			
Retained profit	200	30	a	18			209
			b	3			
Long term loan	–	50					50
Creditors	100	–					100
NCI	–	–			b	13	13

(III) Consolidated balance sheet

M Bhd and its subsidiary
Consolidated balance sheet
as at 31 December 20X9

	RM'000
Land	550
Debtors	200
Bank	122
	872

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	RM'000
Share capital	500
Retained profit	209
Non-controlling interest	13
Long term loan	50
Creditors	100
	872

Notes to the solution:

(1) The group's share of subsidiary's retained profit of RM27,000 (90% × RM30,000) is apportioned into "pre-acquisition" of RM18,000 (90% × RM20,000) which is eliminated against investment account in consolidation journal entry (a), and "post- acquisition" of RM9,000 (90% × RM10,000) which is added to the group's retained profit.

(2) Non-controlling interest is equal to non-controlling shareholding percentage multiplied by subsidiary's net assets as at 31 December 20X9 (10% × RM130,000 = RM13,000), without regard to the apportionment of subsidiary's retained profit into pre-acquisition and post-acquisition.

3.4 INTRAGROUP ACCOUNT BALANCES

Entities in a group may trade or enter into any transactions with each other. These intragroup transactions give rise to several problems in the consolidation process.

In this section, one of the problems arising from intragroup transactions (also referred to as inter-company transactions), namely intragroup account balances, will be discussed. MFRS 10 provides that these intragroup account balances should be eliminated in full (paragraph B86).

When parent enters into a transaction with its subsidiary, (or vice versa), it will record the transaction in its books, like any other transactions entered into with other entities outside the group. For example, if parent makes sales to its subsidiary, the parent will record "sales" (or "sales to subsidiary") in its books, and the subsidiary will record "purchases" (or "purchases from parent") in its books. However, in consolidation, when the parent and the subsidiary are deemed to be a single (economic) entity, it would not make sense to report in the consolidated financial statements that the group sells goods to itself or buys goods from itself. Therefore, in consolidation, these "intragroup accounts" would have to be eliminated, and eliminated in full. Similarly, if the subsidiary has not paid for the purchases in the above transaction, the subsidiary will report in its balance sheet a "trade creditor" (or "amount due to parent"), and the parent will report in its balance sheet a "trade debtor" (or "amount due from subsidiary"). Again it does not make sense to report the trade creditor and the trade debtor in the consolidated balance sheet, as the group cannot logically owe itself any money. Thus, the intragroup trade debtor and creditor would have to be fully eliminated in the consolidation process.

Sometimes, intragroup account balances may not be equal to each other due to cash or goods in transit. For example, assume that the parent grants a loan of RM100,000 to the subsidiary in 20X2. Assume also that the subsidiary repays RM20,000 to the parent on 30 December 20X2 which the parent receives on 3 January 20X3. Thus, as at 31 December 20X2, the subsidiary's balance sheet will show a "Loan due to parent of RM80,000", whereas the parent company's balance sheet will show a "Loan due from subsidiary of RM100,000". It may also be noted that, in this case, the RM20,000 of cash-in-transit will not be reflected in either company's balance sheets.

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The easiest way to resolve the above problem is to first make an adjustment for the cash-in-transit as if the parent has received the payment (Dr Cash RM20,000 and Cr Loan due from subsidiary RM20,000). After this CJE, the intragroup loan balances will be equal in amount, and will be eliminated accordingly. Also, the RM20,000 cash-in-transit will also be reflected in the consolidated balance sheet.

Illustrative Example 3.4

The financial statements of B Bhd and C Bhd for the year 20X8 are as follows:

(a) Statements of comprehensive income for the year ended 31 December 20X8:

	B Bhd RM'000	C Bhd RM'000
Sales	800	500
Less cost of sales	500	300
Gross profit	300	200
Add interest income	1	–
Less distribution expenses	66	59
administrative expenses	35	20
Profit from operations	200	121
Less interest expenses	–	1
Profit before tax	200	120
Less tax	60	30
Profit after tax	140	90
Other comprehensive income	–	–
Total comprehensive income	140	90

(b) Balance sheets as at 31 December 20X8:

	B Bhd RM'000	C Bhd RM'000
Land	200	200
Investment in C Bhd	160	–
Stock	200	100
Trade debtors	140	70
Bills receivable	6	–
Bank	44	30
	750	400

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	B Bhd RM'000	C Bhd RM'000
Share capital	500	100
Retained profit	160	230
Trade creditors	90	60
Bills payable	–	10
	750	400

(c) Statements of changes in equity (partial) for the year ended 31 December 20X8:

	B Bhd RM'000	C Bhd RM'000
Beginning retained profit	90	140
Add profit for the year	140	90
Less dividend	70	–
Ending retained profit	160	230

B Bhd acquired 80% of C Bhd's issued share capital on 31 December 20X5. At that date C Bhd's retained profit was RM100,000.

During the year 20X8, B Bhd sold merchandise of RM100,000 to C Bhd. All these goods were sold by C Bhd to third parties during the year. As at 31 December 20X8, C Bhd has paid RM80,000 for the goods purchased from B Bhd, but B Bhd has only received RM70,000 thereof. Besides the RM20,000 unpaid on account, C Bhd has given several negotiable instruments (bills payable) to B Bhd promising to pay a total of RM10,000 in June 20X9. B Bhd has discounted some of the bills with a total of RM4,000 with the discount houses in December 20X8. The interest expenses of C Bhd represent the interest on the bills paid to B Bhd.

Required: Prepare the consolidated statement of comprehensive income, the consolidated balance sheet and the consolidated statement of changes in equity (showing group retained profit only) for B Bhd and its subsidiary for the year 20X8.

Solution:

(I) Consolidation journal entries (CJE)

		Dr	Cr	
(a)	Dr Share capital (C)	80		
	Dr Beginning retained profit (C)	80		(80% × 100)
	Cr Investment in C		160	
	(to eliminate Investment account)			
(b)	Dr Sales	100		
	Cr Cost of sales (Purchases)		100	
	(to eliminate intragroup account balances)			

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5(1)(b) (which provides that a company is deemed to be a subsidiary of another company if the first-mentioned company is a subsidiary of any company which is that other company's subsidiary). It may be noted that effective interest (in the above case A Bhd has only 42% effective interest in C Bhd) is not relevant to the issue of determining parent-subsidiary relationship.

It therefore follows that when A Bhd in diagram 5A prepares the consolidated financial statements, it has to incorporate the financial statements of A Bhd, those of B Bhd as well as those of C Bhd. (B Bhd of course has to prepare its consolidated financial statements incorporating the financial statements of B Bhd and those of C Bhd, unless it chooses not to, under paragraph 4(a) of MFRS 10).

The preparation of the consolidated financial statements for B Bhd and its subsidiary C Bhd has been extensively discussed in the previous chapters. The focus of discussion in this chapter will be the preparation of consolidated financial statements of A Bhd and its subsidiary B Bhd and sub-subsidiary C Bhd.

There are two methods that can be used to prepare the consolidated financial statements for groups with father-son-grandson structure.

(1) The "consolidation of consolidation" method (also referred to as "direct consolidation", "sequential consolidation" and "two-stage consolidation"); and

(2) The "indirect interest" method (also referred to as "indirect consolidation", "multiple consolidation" and "one-stage consolidation").

The consolidation of consolidation method involves a series of consolidation, starting with the most junior subsidiary. For a group with father-son-grandson structure as the one shown in diagram 5A, the first step is to consolidate the financial statements of C Bhd with those of B Bhd to obtain the consolidated financial statements of B Bhd, and the second step is to consolidate the consolidated financial statements of B Bhd with the financial statements of A Bhd. This method is easy in the sense that it merely involves doing the consolidation process, based on the principles and techniques as already discussed in the previous chapters, repetitively for each level of parent-subsidiary relationship.

The indirect interest method, on the other hand, involves only one consolidation process covering all the entities in the group. However, it requires the calculation and use of both the actual shareholding and effective shareholding percentages. The share capital and pre-acquisition Retained profit of the sub-subsidiary will be apportioned to the group and non-controlling interest based on actual shareholding percentage, whilst the post-acquisition Retained profit of the sub-subsidiary will be apportioned to the group and non-controlling interest based on the effective shareholding percentage. Thus, for the group shown in diagram 5A, the share capital and pre-acquisition Retained profit of C Bhd will be apportioned based on actual shareholding percentage of 60% to the group and 40% to non-controlling interest, whilst the post-acquisition Retained profit of C Bhd will be apportioned based on effective shareholding of 42% (70% × 60%) to the group and 58% (40% + 30% × 60%) to non-controlling interest. The effective shareholding percentage is used to apportioned the post-acquisition Retained profit of the sub-subsidiary to the group and to the non-controlling interest, because, with reference to diagram 5A above, if C Bhd makes RM100, 60% thereof (that is RM60) will go to B Bhd; and of the RM60 that goes to B Bhd, 70% thereof (that is RM42) will ultimately go to A Bhd. Thus, the group's share of C Bhd's post-acquisition profits is based on the effective shareholding of 42%. As for non-controlling interest, it will first get RM40 (based on its direct shareholding of 40%) of C Bhd's profit; and of the RM60 of C Bhd that goes to B Bhd, non-controlling interest will have another 30% interest. Thus non-controlling interest will get a total of RM58 (RM40 + 30% × RM60), based on its effective shareholding of 58% (direct interest of 40% plus indirect interest of 18% (30% × 60%)). The share capital and pre-acquisition Retained profit as well as the post-acquisition Retained profit of the subsidiary B Bhd will, of course, be apportioned based on 70% to the group and 30% to non-controlling interest because the actual shareholding percentage and effective shareholding are the same.

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Both the methods are commonly used in practice for the preparation of the published consolidated financial statements. The consolidation of consolidation method can be effectively used in cases where the group has father-son-grandson structure as in diagram 5A, and where there is no intragroup transaction between the ultimate parent and the sub-subsidiary. In this case, B Bhd will have to prepare the consolidated financial statements incorporating B Bhd and C Bhd (unless B Bhd choose not to prepare consolidated financial statements under paragraph 4(a) of MFRS 10). At A Bhd's level, the consolidated financial statements of B Bhd and its subsidiary C Bhd will be available and can simply be incorporated into the consolidated financial statements of A Bhd under the consolidation of consolidation method. However, in cases where the group has many tiers of sub-subsidiaries, time constraint may render it impractical for the ultimate parent to wait for each subsidiary to consolidate with its own subsidiary. Also, in the preparation of certain specific reports like profit forecasts and interim results, the ultimate parent may have to compile the consolidated results without the availability of the consolidated results of its subsidiary and sub-subsidiary. In these cases, the choice of the methods depends solely on the preference of the preparer of consolidated financial statements.

Table 5.1 below shows the result of an empirical test done in the year 1991 on companies listed in the Kuala Lumpur Stock Exchange (now Bursa Malaysia). As can be seen, more than 50% of the companies used the "consolidation of consolidation" method, while only 22% of the companies used the "indirect interests" method. The popularity of the "consolidation of consolidation" method could be due to the fact that, in Malaysia, every parent, unless it is a wholly owned subsidiary of another entity and it chooses not to prepare consolidated financial statements under the relevant accounting standards (now paragraph 4(a) of MFRS 10), has to prepare and present the consolidated financial statements. For a group with father-son-grandson structure, the subsidiary ("son") would have prepared the consolidated financial statements incorporating its financial statements with those of the sub-subsidiary ("grandson"), thus, at the parent ("father") level, the consolidated financial statements of the group could be conveniently prepared by simply consolidating the consolidated account of the subsidiary and sub-subsidiary with the financial statements of the holding company using the "consolidation of consolidation" method. It is interesting to note that there are 2 companies that employ both the methods in the preparation of the consolidated financial statements for the group. One of these companies stated that it used the "indirect interests" method for the preparation of management financial statements, and the "consolidation of consolidation" method for audit purposes. It is obviously a good practice to use one method to prepare the consolidated financial statements and use another method to verify the resultant consolidated figures.

TABLE 5.1
Consolidation Procedure for Groups with Complex Structure

Alternatives	Frequency	Percentage
A	25	52
B	11	22
C	11	22
D	2	4
Total	49	100

Legends:
A: "Consolidation of consolidation" method
B: "Indirect interests" method
C: Not applicable
D: Others

The application of both the consolidation of consolidation method and the indirect interest method will now be illustrated.

Illustrative Example 5.1

The 31 December 20X8 balance sheets of 3 companies in a group are as follow:

	A Bhd	*B Bhd*	*C Bhd*
	RM'000	*RM'000*	*RM'000*
Share capital	100	60	50
Retained profit	45	51	25
	145	111	75
Investment			
45,000 shares in B Bhd	70	–	–
30,000 shares in C Bhd	–	36	–
Other net assets	75	75	75
	145	111	75

The share capital of A Bhd, B Bhd, and C Bhd comprises 100,000 shares, 60,000 shares, and 50,000 shares, respectively.

The shareholdings were acquired on 1 January 20X1, when B Bhd Retained profit were RM20,000 and C Bhd Retained profit were RM10,000.

Required: Prepare the consolidated balance sheet of A Bhd and its subsidiaries as at 31 December 20X8.

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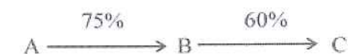
Solution A: Consolidation of Consolidation Method

(I) Group structure



(II) Consolidation journal entries

(1)		B Bhd + C Bhd		
	(a)	Dr Share capital (C) (60% × 50)	30	
		Dr Retained profit (C) (60% × 10)	6	
		Cr Investment in C Bhd		36
		(to eliminate investment account)		
	(b)	Dr Retained profit (C) (60% × (25 – 10))	9	
		Cr Retained profit (B)		9
		(to transfer post-acquisition Retained profit)		
	(c)	Dr Share capital (C) (40% × 50)	20	
		Dr Retained profit (C) (40% × 25)	10	
		Cr Non-controlling interest		30
		(to record non-controlling interest)		
(2)		A Bhd + (B Bhd + C Bhd)		
	(d)	Dr Share capital (B) (75% × 60)	45	
		Dr Retained profit (B) (75% × 20)	15	
		Dr Goodwill on consolidation	10	
		Cr Investment in B Bhd		70
		(to eliminate investment account)		
	(e)	Dr Retained profit (B) (75% × (51 – 20 + 9))	30	
		Cr Retained profit (A)		30
		(to transfer post-acquisition Retained profit)		
	(f)	Dr Share capital (B) (25% × 60)	15	
		Dr Retained profit (B) (25% × (51 + 9))	15	
		Cr Non-controlling interest		30
		(to record non-controlling interest)		

(III) Consolidation worksheet

	A Bhd	*B Bhd*	*C Bhd*	*Adjustments*		*Consolidated Balances*
				Dr	*Cr*	
	RM'000	*RM'000*	*RM'000*	*RM'000*	*RM'000*	*RM'000*
Goodwill	–	–	d 10		–	10
Inv in B	70	–	–		d 70	–
Inv in C	–	36	–		a 36	–
Other asset	75	75	75			225

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	A Bhd	B Bhd	C Bhd	Adjustments Dr	Adjustments Cr	Consolidated Balances
	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
SC-A	100	–	–			100
SC-B	–	60	–	d 45 f 15		–
SC-C	–	–	50	a 30 c 20		–
RP-A	45	–	–		c 30	–
RP-B	–	51	–	d 15 e 30 f 15	b 9	75
RP-C	–	–	25	a 6 b 9 c 10		–
NCI	–	–	–		c 30 f 30	60

(IV) Consolidated balance sheet

A Bhd and its subsidiaries
Consolidated balance sheet
As at 31 December 20X8

	RM'000
Goodwill on consolidation	10
Other net assets	225
	235
Share capital	100
Retained profit	75
Non-controlling interest	60
	235

Solution B: Indirect Interest Method

(I) Group structure

	B Bhd	C Bhd	
Group			
Direct	75%	–	
Indirect	–	45%	(75% × 60%)
MI			
Direct	25%	40%	
Indirect	–	15%	(25% × 60%)

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(II) Consolidation journal entries

(a)	Dr Share capital (B) (75% × 60)	45	
	Dr Share capital (C) (60% × 50)	30	
	Dr Retained profit (B) (75% × 20)	15	
	Dr Retained profit (C) (60% × 10)	6	
	Dr Goodwill on consolidation	10	
	Cr Investment in B Bhd		70
	Cr Investment in C Bhd		36
	(to eliminate investment accounts)		
(b)	Dr Retained profit (B) (75% × (51 – 20))	23.25	
	Dr Retained profit (C) (45% × (25 – 10))	6.75	
	Cr Retained profit (A)		30
	(to transfer post-acquisition Retained profit)		
(c)	Dr Share capital (B) (25% × 60)	15	
	Dr Share capital (C) (40% × 50)	20	
	Dr Retained profit (B) (25% × 51)	12.75	
	Dr Retained profit (C) (40% × 10)	4	
	Dr Retained profit (C) (55% × (25 – 10))	8.25	
	Cr Non-controlling interest		60
	(to record non-controlling interest)		

(III) Consolidation worksheet

	A Bhd	B Bhd	C Bhd	Adjustments Dr	Adjustments Cr	Consolidated Balances
	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
Goodwill	–	–	–	a 10		10
Inv in B	70	–	–		a 70	–
Inv in C	–	36	–		a 36	–
Other assets	75	75	75			225
SC-A	100	–	–			100
SC-B	–	60	–	a 45 c 15		–
SC-C	–	–	50	a 30 c 20		–
RP-A	45	–	–		b 30	75
RP-B	–	51	–	a 15 b 23.25 c 12.75		–

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	A Bhd	B Bhd	C Bhd	Adjustments Dr	Adjustments Cr	Consolidated Balances
	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
RP-C	–	–	25	a 6		
				b 6.75		
				c 4		
				c 8.25		–
NCI	–	–	–		c 60	60

(IV) Consolidated balance sheet

A Bhd and its sub-sidiaries
Consolidated balance sheet
As at 31 December 20X8

	RM'000
Goodwill on consolidation	10
Other net assets	225
	235
Share capital	100
Retained profit	75
Non-controlling	60
	235

Notes to the solution:

(1) Both the consolidation of consolidation method and the indirect interest method yield the same consolidated balance sheet.

(2) Under the consolidation of consolidation method, two consolidation processes are carried out. The first process is to consolidate the financial statements of C Bhd with those of B Bhd and the second process is to consolidate the consolidated financial statements of B Bhd and its subsidiary C Bhd with the financial statements of A Bhd.

(3) Under the indirect interest method, only one consolidation process is carried out. The financial statements of all the companies in the group are consolidated at the same process. However, two different shareholding percentages are used, the actual shareholding percentage is used to apportion pre-acquisition Retained profit and the effective shareholding percentage is used to apportion post-acquisition Retained profit.

(4) The group retained profit of RM75,000 may be proved as follows:

	RM'000
A Bhd's retained profit	45
Group's share of B Bhd's post-acquisition reserve	
75% × (51–20)	23.25
Group's share of C Bhd's post-acquisition reserve	
75% × 60% × (25–10)	6.75
	75

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(5) The non-controlling interest of RM60,000 may be proved as follows:

	RM'000
Non-controlling's direct interest in B Bhd	
25% × 111	27.75
Non-controlling's direct interest in C Bhd	
40% × 75	30
Non-controlling's indirect interest in C Bhd	
25% × 60% × (25–10)	2.25
	60

(Note that non-controlling's direct interest entitles it to a share of the net assets of the subsidiary, while non-controlling's indirect interest only entitles it to a share of the post-acquisition reserve of the subsidiary)

In illustrative example 5.1 above, it is assumed that all the companies in the group acquire their respective shareholding on the same date. If the respective shareholdings are acquired on different dates, certain complications may arise.

If A Bhd acquires B Bhd before B Bhd acquires C Bhd, there is no complication. This is because C Bhd becomes a subsidiary of B Bhd group and a subsidiary of the A Bhd group on the same date, i.e., the date it was acquired by B Bhd.

However, if A Bhd acquires B Bhd after B Bhd has acquired C Bhd, complications would arise. This is because, in this case, C Bhd becomes a subsidiary of B Bhd group on the date it was acquired by B Bhd, but becomes a subsidiary of the A Bhd group only at a later date when B Bhd is acquired by A Bhd. Viewed from a different angle, the complications arise because when A Bhd acquires B Bhd, B Bhd already has a subsidiary, C Bhd, and thus when A Bhd acquires B Bhd, it not only acquires B Bhd, but also C Bhd. This seems like a complicated situation. However, it can be resolved quite easily in the consolidation process by treating the increase or decrease in C Bhd's Retained profit from the date it was acquired by B Bhd to the date B Bhd was acquired by A Bhd, as post-acquisition Retained profit from the viewpoint of B Bhd group but as pre-acquisition Retained profit from the viewpoint of A Bhd group.

Thus, under the consolidation of consolidation method, at A Bhd's level of consolidation, B Bhd's share of the increase or decrease in C Bhd's Retained profit from the date B Bhd acquires C Bhd to the date A Bhd group acquires B Bhd will be treated as part of B Bhd's pre-acquisition Retained profit at the date it is acquired by A Bhd and eliminated against A Bhd's investment account.

Under the indirect interest method, the amount of C Bhd's reserve that is to be treated as pre-acquisition and eliminated against the investment account is its Retained profit as at the date when B Bhd was acquired by A Bhd.

Illustrative Example 5.2

(This illustrative example is based on the case in illustrative example 5.1, incorporating amendments made to the dates of acquisition. In this case, A Bhd acquires B Bhd before B Bhd acquires C Bhd).

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The 31 December 20X8 balance sheets of 3 companies in a group are as follow:

	A Bhd	*B Bhd*	*C Bhd*
	RM'000	*RM'000*	*RM'000*
Share capital	100	60	50
Retained profit	45	51	25
	145	111	75
Investment			
45,000 shares in B Bhd	70	–	–
30,000 shares in C Bhd	–	36	–
Other net assets	75	75	75
	145	111	75

The share capital of A Bhd, B Bhd, and C Bhd comprises 100,000 shares, 60,000 shares, and 50,000 shares, respectively.

A Bhd acquires B Bhd in 20X3, when B Bhd's Retained profit were RM20,000.

B Bhd acquires C Bhd in 20X5, when C Bhd's Retained profit were RM10,000.

Required: Prepare the consolidated balance sheet of A Bhd and its subsidiaries as at 31 December 20X8.

Solution:

The solution will be exactly the same as the solution to illustrative example 5.1

Notes to the solution:

(1) Under the consolidation of consolidation method, the post- acquisition Retained profit transferred from C Bhd to B Bhd (CJE (b)) will also be in the nature post-acquisition Retained profit from the viewpoint of A Bhd. This is because C Bhd became a subsidiary of B Bhd in 20X5 and deemed to be a subsidiary of A Bhd also in 20X5 when B Bhd became a subsidiary of A Bhd and thus C Bhd's Retained profit after 20X5 are in the nature of post-acquisition from the viewpoints of both B Bhd and A Bhd.

(2) Under the indirect interest method, C Bhd will be consolidated on the basis that it became a subsidiary of the group in 20X5, the later of the two dates of acquisition.

Illustrative Example 5.3

(This illustrative example is based on the case in illustrative example 5.1, incorporating amendments made to the dates of acquisition. In this case, A Bhd acquires B Bhd after B Bhd acquires C Bhd).

The 31 December 20X8 balance sheets of 3 companies in a group are as follow:

	A Bhd	*B Bhd*	*C Bhd*
	RM'000	*RM'000*	*RM'000*
Share capital	100	60	50
Retained profit	45	51	25
	145	111	75

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	A Bhd	*B Bhd*	*C Bhd*
	RM'000	*RM'000*	*RM'000*
Investment			
45,000 shares in B Bhd	70	–	–
30,000 shares in C Bhd	–	36	–
Other net assets	75	75	75
	145	111	75

The share capital of A Bhd, B Bhd, and C Bhd comprises 100,000 shares, 60,000 shares, and 50,000 shares, respectively.

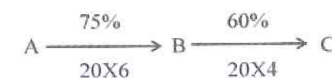
B Bhd acquires C Bhd in 20X4, when C Bhd's Retained profit were RM10,000.

A Bhd acquires B Bhd in 20X6, when B Bhd's Retained profit were RM20,000. At this date, C Bhd's Retained profit were RM15,000.

Required: Prepare the consolidated balance sheet of A Bhd and its subsidiaries as at 31 December 20X8.

Solution A: Consolidation of Consolidation Method

(I) Group structure



(II) Consolidation journal entries

(1)		B Bhd + C Bhd		
	(a)	Dr Share capital (C) (60% × 50)	30	
		Dr Retained profit (C) (60% × 10)	6	
		Cr Investment in C Bhd		36
		(to eliminate investment account)		
	(b)	Dr Retained profit (C) (60% × (25 – 10))	9	
		Cr Retained profit (B)		9
		(to transfer post-acquisition Retained profit)		
	(c)	Dr Share capital (C) (40% × 50)	20	
		Dr Retained profit (C) (40% × 25)	10	
		Cr Non-controlling interest		30
		(to record non-controlling interest)		
(2)		A Bhd + (B Bhd + C Bhd)		
	(d)	Dr Share capital (B) (75% × 60)	45	
		Dr Retained profit (B) (75% × (20 +60% ×(15 – 10))	17.25	
		Dr Goodwill on consolidation	7.75	
		Cr Investment in B Bhd		70
		Cr Negative goodwill		2.25
		(to eliminate investment account)		

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(e)	Dr Retained profit (B) (75% × (51 – 20 + (60% × (25 – 15))	27.75	
	Cr Retained profit (A)		27.75
	(to transfer post-acquisition Retained profit)		
(f)	Dr Share capital (B) (25% × 60)	15	
	Dr Retained profit (B) (25% × (51 + 9))	15	
	Cr Non-controlling interest		30
	(to record non-controlling interest		

(III) Consolidation worksheet

	A Bhd	*B Bhd*	*C Bhd*	*Adjustments Dr*	*Cr*	*Consolidated Balances*
	RM'000	*RM'000*	*RM'000*	*RM'000*	*RM'000*	*RM'000*
Goodwill	–	–	–	d 7.75		7.75
Inv in B	70	–	–		d 70	–
Inv in C	–	36	–		a 36	–
Other assets	75	75	75			225
SC-A	100	–	–			100
SC-B	–	60	–	d 45 f 15		–
SC-C	–	–	50	a 30 c 20		–
RP-A	45	–	–		e 27.75	72.75
RP-B	–	51	–	d 17.25 e 27.75 f 15	b 9	–
RP-C	–	–	25	a 6 b 9 c 10		–
NCI	–	–	–		c 30 f 30	60

(IV) Consolidated balance sheet

A Bhd and its subsidiaries
Consolidated balance sheet
As at 31 December 20X8

	RM'000
Goodwill on consolidation	7.75
Other net assets	225.00
	232.75

	RM'000
Share capital	100.00
Retained profit	72.75
Non-controlling interest	60.00
	232.75

Solution B: Indirect Interest Method

(I) Group structure

	B Bhd	*C Bhd*	
Group			
Direct	75%	–	
Indirect	–	45%	(75% × 60%)
MI			
Direct	25%	40%	
Indirect	–	15%	(25% × 60%)

(II) Consolidation journal entries

(a)	Dr Share capital (B) (75% × 60)	45	
	Dr Share capital (C) (60% × 50)	30	
	Dr Retained profit (B) (75% × 20)	15	
	Dr Retained profit (C) (60% × 10)	6	
	Dr Retained profit (C) (45% × (15 – 10)	2.25	
	Dr Goodwill on consolidation	7.75	
	Cr Investment in B Bhd		70
	Cr Investment in C Bhd		36
	(to eliminate investment accounts)		
(b)	Dr Retained profit (B) (75% × (51 – 20))	23.25	
	Dr Retained profit (C) (45% × (25 – 15))	4.5	
	Cr Retained profit (A)		27.75
	(to transfer post-acquisition Retained profit)		
(c)	Dr Share capital (B) (25% × 60)	15	
	Dr Share capital (C) (40% × 50)	20	
	Dr Retained profit (B) (25% × 51)	12.75	
	Dr Retained profit (C) (40% × 10)	4	
	Dr Retained profit (C) (55% × (25 – 10))	8.25	
	Cr Non-controlling interest		60
	(to record non-controlling interest)		

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(5) The amount of group ending retained profit can be proved as equal to the amount of adjusted profit retained in the parent plus the amounts of group's share of the post-acquisition adjusted profits retained in the subsidiaries and associates. In this case, the group retained profit of RM541,000 can be proved as follow: amount retained in P Bhd of RM500,000 plus amount retained in S Bhd of RM6,000 (60% × RM10,000) plus amount retained in A Bhd of RM35,000 (25% × (RM440,000 – RM300,000)).

(6) It does not matter which entity, the subsidiary or the associate, is to be adjusted first in the consolidation process (unlike the case of indirect shareholding, to be discussed in sub-section 6.8 below).

The above illustrative example assumes a simple case where there is no difference between the cost of acquisition and the underlying net assets, and that there is no transaction between the investor and its associate.

The issues involved in cases where there is a difference between the cost of investment and the underlying net assets are discussed in section 6.4. The issues relating to intragroup transactions are discussed in section 6.5.

6.4 DIFFERENCE BETWEEN COST AND UNDERLYING NET ASSETS

As in the case of parent-subsidiary discussed in Chapter 2, there may also differences between the investor's cost of investment in associate and the investor's proportionate share of the associate's net assets. These differences, again like in the case of parent-subsidiary, may arise due to (a) over/under valuation of associate's assets and liabilities or unrecorded intangible assets and contingent liabilities, and/or (b) existence of goodwill or negative goodwill.

Where the associate's assets and liabilities are over or under valued and/or where there are unrecorded intangible asset and contingent liabilities, the consolidation treatment of these items in the case of investor-associate is very different from that in the case of parent-subsidiary discussed in Chapter 2. Unlike in the case of parent-subsidiary, no fair value adjustment of the over/under valued assets and liabilities and no recognition of the unrecorded intangible assets and contingent liabilities are necessary in the case of investor-associate. The differences are simply carried as part of the cost of the "Investment in associate" account. To illustrate, assume that P Bhd pays RM120 to acquire a 40% interest in A Bhd whose net assets are represented by share capital of RM100 and retained profit of RM100, and the excess payment of RM40 (RM120 – 40% × RM200) is due to undervaluation of A Bhd's Machinery of RM20 and a unrecorded Brand of RM20. In this case, the Investment in associate will be carried at RM120, and A Bhd's Machinery and Brand will not be adjusted/recognised in the consolidated balance sheet.

MFRS 128 provides, however, that appropriate adjustments to the investor's share of associate's profit or loss should be made to account for depreciation of the depreciable asset based on their fair value at the acquisition date (para 32). To illustrate, refer to the above case and assume that A Bhd's Machinery is to be depreciated using straight line method and has a remaining useful life of 4 years. Applying the requirement of paragraph 32, P Bhd's share of the A Bhd's profit is to be reduced by RM5 per year over the next 4 years. (Assume that there is no amortisation and no impairment of the Brand.)

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Where there is goodwill, MFRS 128 provides that goodwill relating to an associate should be included in the carrying amount of the investment (para 32). MFRS 128 further provides that, amortisation of that goodwill is not permitted (to be consistent with goodwill accounting under MFRS 3). To illustrate, assume that H Bhd pays RM50 to acquire a 40% in an associate whose net assets have a fair value of RM100. In this case, the goodwill of RM10 (RM50 – 40% × RM100) will not be separately recorded and also will not be amortised; it will be carried as part of the cost of investment. In the consolidated balance sheet, the investment in associate will be carried at RM50, and there is no goodwill account. MFRS 128 further provides that, because goodwill included in the carrying amount of the investment in associate is not separately recognised, it is not tested for impairment separately (para 42). Instead, the entire carrying amount of investment is tested for impairment under MFRS 136.

For associates acquired before the adoption of MFRS 128 and MFRS 3, the goodwill element embedded in the cost of investment may or may not have been amortised. In any case, with the adoption of MFRS 128 and MFRS 3, the amortisation should immediately cease, and the unamortized amount of goodwill, if any, will be carried as part of the cost of investment.

If there is negative goodwill, paragraph 32 of MFRS 128 requires the negative goodwill to be excluded from the carrying amount of the investment and written off immediately to the consolidated statement of comprehensive income in the year of investment (again, this is consistent with negative goodwill accounting under MFRS 3). To illustrate, assume in the above case, H Bhd pays RM35, instead of RM50, thereby giving rise to a negative goodwill of RM5. In this case, the negative goodwill of RM5 will be written off immediately to the consolidated statement of comprehensive income, and the investment will be carried at RM40. The CJE will be as follows: Dr Investment in associate RM5 and Cr Other income RM5.

For associates acquired before the adoption of MFRS 128 and MFRS 3, the negative goodwill element embedded in the cost of investment may or may not have been amortised. In any case, with the adoption of MFRS 128 and MFRS 3, the unamortized amount of negative goodwill, if any, embedded in the cost of investment should be written off to beginning retained profit, as follows: Dr Investment in associate and Cr Beginning retained profit.

Illustrative Example 6.2

On 2 January 20×8, A Bhd pays RM40,000 to acquire 30% of B Bhd whose net assets are represented by share capital of RM100,000.

The excess payment of RM10,000 (40,000 – 30% × 100,000) is analysed as follow:

- RM5,000 for goodwill,
- RM4,000 for undervaluation of machinery,

- RM3,000 for undervaluation of land, and
- RM2,000 for overvaluation of stocks-on-hand.

The machinery has remaining useful life of 4 years and is depreciated using straight line, the land is not subject to amortisation, and the stock is sold during the year 20×8.

For the year ended 31 December 20×8, B Bhd reports a pre-tax profit of RM10,000 and after-tax profit of RM7,000.

In consolidation, the following CJEs will be required:

		Dr	Cr
(a)	Dr Investment in associate	2,100	
	Cr Share of profit of associate		2,100
	(share of associate's profit)		
(b)	Dr Share of profit of associate	1,000	
	Cr Investment in associate		1,000
	(additional depreciation on undervalued machinery)		
(c)	Dr Investment in associate	2,000	
	Cr Share of profit of associate		2,000
	(overvaluation of stock)		

Notes to the solution:

(1) CJE (a) is to equity account for the associate's profit.

(2) A Bhd's share of B Bhd's profit will be reduced by additional depreciation on machinery of RM1,000 (CJE (b)), and increased by the sale of the overvalued stock of RM2,000 (CJE (c)).

(3) There is no income effect arising from Goodwill.

(4) There is also no income effect arising from undervaluation of Land. However, in the year when the Land is sold, A Bhd's share of the profit thereof should be reduced by RM3,000 (or share of loss on disposal increased by RM3,000).

(5) Note that, unlike in the case of subsidiary, there is no need to revalue the identifiable assets of the associate (ie no fair value adjustment is required of associate's assets and liabilities). This is because, in the consolidated financial statements, the assets and liabilities of the associate are not added to those of the investor, on a line-by-line basis. The fair value differences are simply carried as part of the cost of the Investment in associate account.

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6.5 TRANSACTIONS BETWEEN PARENT AND ASSOCIATE

If there are transactions between the investor and its associate, consolidation journal entries along the same lines as in the case of transactions between parent and subsidiary are required, with the following modification:

(1) Only unrealised intragroup profits and losses arising from intragroup transactions are eliminated. Intragroup account balances arising from intragroup transactions are not eliminated.

(2) For unrealised intragroup profits and losses, partial rather than full elimination is used. In other words, only the investor's proportionate interest in the unrealised intragroup profits and losses are adjusted for.

To illustrate, assume that P Bhd has a 40% interest in an associate, A Bhd. During 20×8, P Bhd sells goods invoiced at RM100 to A Bhd. As at 31 December 20×8, some of these goods remain in the store of A Bhd, and there is an unrealized profit of RM20. In this case, for the 20×8 consolidation, (i) the inter-company sales and purchase are not eliminated, and (ii) only 40% of the unrealized gain is eliminated.

If there is unrealized loss arising from the transaction between parent and its associate, the same rules apply. However, if the loss is not recoverable, MFRS 128 requires 100% the non-recoverable unrealized loss arising from downstream transactions to be eliminated (paragraph 29). For non-recoverable unrealized loss arising from upstream transactions, MFRS 128 requires that only parent's proportionate share of the loss is eliminated (para 29).

To illustrate the requirement of paragraph 29, assume that H Bhd has a 30% interest in A Bhd, and that during the year, there is an inter-company sales, and none of the goods are sold to outsider by the year end. Assume the four independent scenarios below:

In scenario I, A Bhd buys good for RM100 and sells them to H Bhd for RM60, even though the net realizable value of the goods is more than RM100. In this scenario, only 30% of the unrealised loss (30% × RM40 = RM12) should be eliminated in the consolidated financial statements.

In scenario II, H Bhd buys good for RM100 and sells them to A Bhd for RM60, even though the net realizable value of the goods is more than RM100. In this scenario, only 30% of the unrealised loss (30% × RM40 = RM12) should be eliminated in the consolidated financial statements.

In scenario III, A Bhd buys good for RM100 and sells them to H Bhd for RM60, because the goods are damaged and the net realizable value of the goods is RM60. In this scenario, only 30% of the unrealised loss (30% × RM40 = RM12) should be eliminated in the consolidated financial statements.

In scenario IV, H Bhd buys good for RM100 and sells them to A Bhd for RM60, because the goods are damaged and the net realizable value of the goods is RM60. In this scenario, 100% of the unrealised loss (100% × RM40 = RM40) should be eliminated in the consolidated financial statements.

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Further, there may be unrealized gain/loss arising from investor's contribution of a non-monetary asset to an associate in exchange for an equity interest in the associate.

In a case where an investor contributes a non-monetary asset to an associate in exchange for an equity interest in the associate, a question arises as to whether the investor should recognize gain or loss arising therefrom. MFRS 128 provides that the investor should recognize gain or loss arising therefrom unless there is no commercial substance in the transaction (paragraph 30).

To illustrate the requirement of paragraph 30, assume that × Bhd contributes a piece of land to A Bhd in exchange for 25% equity interest in A Bhd (which is deemed to have a fair value of RM560 million). Assume further that the land was carried in × Bhd' financial statement at RM100 million, and the fair value of A Bhd's 25% equity interest is RM140 million (25% × RM560 million). In this case, × Bhd is required to recognize, in its separate financial statements, the gain arising therefrom through an journal entry: Dr Investment in associate RM140 million; Cr Land RM100 million; and Cr Gain on disposal of land RM40 million.

To illustrate a case of a transaction without commercial substance, assume that Y Bhd and 3 other parties, each contributes a piece of land (of equal fair value) to A Bhd and each is allotted 25% equity interest in A Bhd. In this case, there is no commercial substance in the transaction. Assuming the land was carried in Y Bhd' financial statement at RM100 million, Y Bhd will record the transaction through a journal entry: Dr Investment in associate RM100 million; and Cr Land RM100 million.

Where an investor contributes a non-monetary asset to an associate in exchange for an equity interest in the associate and recognizes gain or loss arising therefrom, MFRS 128 provides that any gain/loss that is deemed unrealized at group level should be eliminated against the investment account (paragraph 30).

To illustrate, assume the case of × Bhd above where × Bhd contributes a piece of land to A Bhd in exchange for 25% equity interest in A Bhd, and × Bhd thereby recognizes a gain on disposal of land of RM40 million in its separate financial statements. Assume that × Bhd has investment in subsidiaries and therefore prepares consolidated financial statements. It may be appreciated that, at group level, RM10 million (25% × RM40 million) of the gain on disposal of land is unrealized (because it is as if × Bhd is selling 25% of the land back to itself). Thus, a consolidation adjusting entry is required to eliminate the unrealized gain: Dr Gain on disposal of land RM10 million; and Cr Investment in associate RM10 million.

MFRS 128 is silent on how to account for the partial elimination of the unrealised profit or loss. However, in practice, there are several alternative consolidation journal entries that are used to eliminate the unrealised profits and losses.

One approach that is commonly used in the American accounting literature is to adjust the unrealised profits and losses through the Investment in associate account and the Share of profit of associate account, irrespective of whether the transaction is upstream or downstream. For example, assume there is a unrealised profit in intragroup sale of stock. The accounting entry will be Dr Share of profit of associate; Cr Investment in associate. The

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rationale is that since the intragroup profits and losses are deemed to be unrealised because of equity accounting, the adjustment should therefore be made against the equity accounts involved, that is, Investment in associate account and Share of profit of associate account.

Another approach that is commonly used, especially in Australian accounting literature, follows closely the principles of consolidation of subsidiary company. For example, assume there is unrealised profit in intragroup sale of stock. If the transaction is downstream, the accounting entry will be Dr Profit before tax; Cr Investment in associate. The argument is that in downstream transaction, the unrealised profit is recorded in investor's books and the "overvalued" stock is recorded in investee's books. Therefore when the unrealised profit is eliminated, the investor's profit will be reduced (Dr Profit before tax). Also, the investee's net asset (stock) will be reduced and therefore the investment must be reduced (Cr Investment in associate). On the other hand, if the transaction is upstream, the accounting entry is Dr Share of profit of associate; Cr Stock. The argument is that in an upstream transaction, the profit is recorded in investee's books and the stock in investor's books. Therefore when the unrealised profit is eliminated, the investee's profit will be reduced and therefore the share of investee's profit will be reduced (Dr Share of profit of associate). Also, the stock value in investor's books will be reduced (Cr Stock).

A third approach is to Dr Profit before tax; Cr Deferred profit, for downstream transaction. The argument is that in a downstream transaction, the only issue involved is to defer the recognition of the profit that the investor has recorded. No other accounts are affected. For upstream transaction, the accounting entry may be either one of the two approaches mentioned above, that is, Dr Share of profit of associate; and Cr Investment in associate, or Cr Stock.

Illustrative Example 6.3

A Bhd group holds 30% interest in B Bhd and there is an unrealised intragroup profits of RM100 in closing stock.

The alternative consolidated journal entries under each of the three approaches discussed above are:

Approach I

	Dr	Cr
Dr Share of profit of associate	30	
Cr Investment in associate		30
(Downstream transaction)		
Dr Share of profit of associate	30	
Cr Investment in associate		30
(Upstream transaction)		

Approach II

Dr Cost of sales	30	
Cr Investment in associate		30
(Downstream transaction)		
Dr Share of profit of associate	30	
Cr Stock		30
(Upstream transaction)		

Approach III

Dr Cost of sales	30	
Cr Deferred profit		30
(Downstream transaction)		
Dr Share of profit of associate	30	
Cr Investment in associate		30
(Upstream transaction)		

Note:

(1) These CJEs ignores the tax effect on the eliminations of unrealised profits.

As in the case of consolidation of subsidiary, the tax effect can easily be incorporated as follow:

- where the elimination reduces "Profit before tax", the CJE for the tax effect is Dr Deferred tax; Cr Tax expense.
- where the elimination reduces "Share of profit of associate", the CJE for the tax effect is Dr Deferred tax; Cr Share of tax of associate.

However, the tax effect on the elimination of unrealised profits and losses will be ignored in subsequent discussion, as a matter of convenience.

Of the three approaches mentioned, the first approach seems to have the best theoretical backing, and will be used in this book

Here below is a comprehensive illustration on the issues discussed under section 6.4 and 6.5 above.

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Illustrative Example 6.4

H Bhd holds 80% of S Bhd and 40% of A Bhd.

H Bhd acquired its 80% interest in S Bhd, when S Bhd was formed on 10 January 20×8, for a cash consideration of RM80,000.

H Bhd acquired its 40% interest in A Bhd on 31 August 20×5 when A Bhd's retained profit was reported at RM200,000, for a cash consideration of RM150,000. The excess payment is for goodwill. The companies have adopted MFRS 3 and MFRS 128 since 1 January 20×5, and there has been no impairment of goodwill.

During the year 20×8, H Bhd sold goods to A Bhd amounting to RM300,000. On 31 December 20×8, A Bhd's stock included goods invoiced by H Bhd at RM50,000+10%.

On 30 June 20×8, A Bhd sold a piece of land which was carried in its books at RM400,000 to H Bhd for RM500,000. The land was still carried in H Bhd's book on 31 December 20×8.

On 30 September 20×8, A Bhd paid an interim dividend of RM70,000 out of current year's profits. All the companies have adopted the single tier system for dividends since 1 January 20×8.

The financial statements of the 3 companies are as follows:-

(a) Balance sheets as at 31 December 20×8

	H Bhd	*S Bhd*	*A Bhd*
	RM'000	*RM'000*	*RM'000*
Investment in S Bhd	80	–	–
Investment in A Bhd	150	–	–
Amount due from S Bhd	100	–	–
Amount due from A Bhd	50	–	–
Other net assets	420	220	640
	800	220	640
Share capital	200	100	100
Retained profits	600	20	490
Amount due to H Bhd	–	100	50
	800	220	640

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