Similarly, an investor can have the power even if other parties have existing rights to participate in the direction of the relevant activities or hold protective rights, including special rights to veto certain decisions. Protective rights held by other parties may restrict but do not preclude an investor from having the power to direct.

Examples of protective rights provided in the MFRS include, but are not limited to:

(a) a lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender;

(b) the right of a party holding an NCI in an investee to approve capital expenditure greater than that required in the ordinary course of business or to approve the issue of equity or debt instruments; and

(c) the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.

Assessing Relevant Activities

In a straightforward case, when power arises from voting rights (and there are no other arrangements), an investor who holds more than half of the voting rights would have the current ability to direct the relevant activities of the investee. In other cases where voting rights are not the dominant criterion for assessing control or when the assessment of voting rights is not conclusive, an investor would need to consider whether it has, through arrangements or other facts and circumstances, the unilateral ability to direct most of the relevant activities that significantly affect the investee's return. Other parties may have protective rights to some relevant activities, and it is not necessary for an investor to have absolute power to unilaterally direct all relevant activities in this new control model.

Relevant activities are defined for the purpose of this MFRS as ''activities of the investee that significantly affect the investee's return''. Many operating and financing activities can significantly affect an investee's return. The MFRS provides some examples of relevant activities, which may include, but are not limited to:

(a) selling and purchasing of goods or services;

(b) managing financial assets during their life (including upon default);

(c) selecting, acquiring or disposing of assets;

(d) researching and developing new products or processes; and

(e) determining a funding structure or obtaining financing.

In some circumstances, 2 or more unrelated investors each have existing rights that give them the unilateral ability to direct different relevant activities. In such circumstances, the MFRS clarifies that the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee.

For example, Entity A and Entity B are unrelated investors in Entity C. As provided in their contractual arrangement, Entity B has the unilateral ability to direct and determine the funding structure and in obtaining financing for Entity C. Entity A has the unilateral ability to direct the entire manufacturing operations (including acquiring and selling assets) and marketing of the finished goods. It is

concluded that manufacturing and marketing activities combined are more significant than financing activities in affecting the returns of Entity C. In this case, Entity A is deemed to have the power over Entity C.

In some cases, both sets of relevant activities each directed unilaterally by 2 unrelated investors are equally significant in affecting an investee's return. For example, in the above case, Entity A directs the manufacturing operations whilst Entity B directs the marketing operations of Entity C and both sets of activities are equally significant in affecting Entity C's returns. In such a case, neither Entity A nor Entity B has the power. The parties would need to consider MFRS 11 to assess whether their contract is a joint arrangement.

1.2.3.2 The Returns Element

MFRS 10 clarifies that an investor must be exposed, or have rights, to variable returns from its involvement with an investee to control the investee. The former MFRS 127 used the term ''to obtain benefits from its activities'', which might imply only positive returns. In this MFRS, the returns must have the potential to vary as a result of the investee's performance and can be only positive, only negative, or wholly positive and negative [MFRS 10.15]. Thus, returns include not only dividends and other distributions from holding equity instruments in the investee, but may also include upfront fees, access to cash, servicing fee, returns not available to NCI, cost savings, etc.

For example, an investor may transfer a ''loan receivable'' to a structured entity and receives a servicing fee for managing the loan receivable. Similarly, a property developer may transfer a land to a special purpose vehicle and receives income from the land development even though it may hold little or no equity interest in the special purpose vehicle.

1.2.3.3 The Link Element

An investor must not only have power over an investee and exposure or rights to variable returns from its involvement with the investee. It must also have the ability to use its power over the investee to affect its return from its involvement with the investee [MFRS 10.17]. In other words, there must be a *link* between the 2 components of power and returns. For example, if an investor is the majority shareholder of an investee, it receives the most dividends (returns) but if the investor does not have the power to direct the relevant activities (eg due to a contractual arrangement), the investee is not a subsidiary of the investor. Similarly, an entity may have decision-making rights delegated to it when acting as an agent, but it does not have exposure or rights to variable returns, and accordingly, it does not control the investee.

For example, a fund manager of a unit trust fund may have decision-making rights with respect to investments of the fund and thus has the ability to direct the relevant activities (buying or selling investments) unilaterally. However, it is neither exposed nor has rights to variable returns if it only receives a fee acting as an agent of the unit holders of the fund. In this case, there is no link between power and returns.

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> Some asset management entities also invest in their own funds. In such cases, an asset management entity acts both as a principal and as an agent to the funds it manages. It must consider the link between the power element and returns element to determine whether it meets the new control model.

1.2.4 Application of the Control Model

The MFRS sets out the requirements on how to apply this control model in:

(a) circumstances when voting rights or similar rights give an investor power, including situations where the investor holds less than a majority of the voting rights and in circumstances involving potential voting rights;

(b) circumstances when an investee is designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements (eg in determining control of a structured entity);

(c) in circumstances involving agency relationships; and

(d) in circumstances when the investor has control over specified assets (a silo) of an investee.

1.2.4.1 Control by Voting Rights

If the relevant activities of an investee are directed through voting rights, an investor considers whether it has the current ability, through voting or similar rights, to direct the relevant activities. MFRS 10 retains the presumption in the former MFRS 127 that an investor who can exercise *more than a majority* of the voting rights has control of the investee (unless circumstances indicate otherwise). The ''more than a majority'' criterion can be attained by holding, directly or indirectly, more than half the voting equity instruments of an investee or by holding voting equity instruments and having contractual arrangements with other investors.

> For example, an investor owns 40% equity shares of an investee. It enters into an arrangement with another shareholder of the investee to have the power to exercise the other shareholder's 11% voting rights. In this case, the investor's own shareholdings and the arrangement with the other shareholder give it the current ability to exercise more than a majority of the voting rights in the investee.

When no party holds a majority of the voting rights in an investee, and voting rights are clearly the only basis for assessment (in the absence of any additional arrangements altering decision-making), the assessment of control will focus on which party, if any, is able to exercise *voting rights sufficient to direct* the relevant activities of the investee unilaterally [MFRS 10.B41]. When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances, such as: (a) the size of its holding of voting rights relative to the size and dispersion of holdings of other vote holders; (b) potential voting rights, regardless of whether they are currently exercisable or not (the former MFRS 127 required that the potential voting rights must be currently exercisable); and (c) rights from contractual arrangements.

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The MFRS clarifies that when the direction of the relevant activities is determined by a majority vote and an investor holds significantly *more voting rights* than any other vote holders or organised group of vote holders, and the other shareholdings are widely dispersed, it may be clear, after considering the relevant facts and circumstances alone, that the investor has power over the investee [MFRS 10.B43].

> For example, an investor can have the power to direct the relevant activities of a public listed company if the investor is the *dominant* shareholder who holds significant voting rights and all the other shareholders with voting rights are widely dispersed and are not organised in such a way that they actively co-operate when they exercise their votes so as to have more voting power than the investor. In such a case, the investor, being the dominant shareholder, is said to have ''de facto'' control over the investee. This dominant shareholder concept was implicit in the former MFRS 127.

1.2.4.2 Control by Contractual Arrangements

When an investee is designed or structured in a manner that voting rights relate to administrative tasks only but the relevant activities are directed by contractual arrangements, the assessment of control would need to consider those contractual arrangements to decide who is able to direct the relevant activities.

For more complex cases of contractual arrangements (eg when assessing control of structured entities or SPEs), it may be necessary to consider many or all of the following factors to determine whether an investor controls an investee:

(a) what the relevant activities are and how decisions about those activities are made;

(b) whether the rights of the investor give it the current ability to direct those activities;

(c) whether the investor is exposed, or has rights, to variable returns from its involvement with the investee; and

(d) whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns.

This assessment should include the consideration of risks that the investee was designed to create, the risks it was designed to pass on to the parties involved in the transaction and whether the investor is exposed to some or all of those risks. The investor should consider the decisions made at the investee's inception as part of its design, including call rights, put rights or liquidation rights. If these contractual arrangements involve activities that are closely related to the investee, then they are, in substance, an integral part of the investee's relevant activities.

The investee may be designed so that the direction of its activities and its returns are predetermined unless and until those particular circumstances arise or events occur. In this case, only the decisions about the investee's activities when those circumstances or events occur can significantly affect its returns and are thus considered as relevant activities.

Being involved in the design of an investee, although not sufficient, may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee. Similarly, an investor's explicit or implicit commitment to ensure that an investee continues to operate as designed may increase the investor's exposure to the

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variability of returns and thus the likelihood that it has power. The commitment alone, however, neither give an investor power nor does it prevent another party from having power.

1.2.4.3 Agency Relationships

An investor needs to assess whether its relationship with other parties is such that those other parties are acting on the investor's behalf, ie they are "de facto agents". A party is a de facto agent when the investor has, or those that direct the activities of the investee have, the ability to direct that party to act on the investor's behalf. Thus, an investor can control an investee by appointing agents to act on its behalf. But if the investor is acting only as an agent, it does not control the investee.

The MFRS provides examples of such other parties that, by the nature of their relationship, may act as de facto agents of the investor, and these include the investor's related parties, a party that received its interest in the investee as a contribution or loan from the investor; a party that cannot finance its operations without subordinated financial support from the investor; an investee for which the majority of the members of its governing body or for which its key management personnel is the same at that of the investor; and a party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

> For example, Entity P holds a 40% equity interest in Entity S. Three other investors each hold a 20% equity interest in S Bhd. One of the 3 other investors is a director of Entity P. Entity P assesses and concludes that its director would act in the best interest of Entity P. The director is thus a de facto agent of Entity P. The combined voting rights would be 60%. Entity S shall be treated as a subsidiary using the indicator of a de facto agent.

1.2.4.4 Control over Specified Assets (A Silo)

Sometimes, an investor may only have power over specified assets (or over a portion) of an investee. In such cases, the MFRS requires that the investor shall treat the portion of that investee as a separate entity if and only if the following condition is satisfied:

> *"Specified assets of the investee (and related credit enhancements, if any) are the only source of payments for specified liabilities of, or specified other interests in, the investee. Parties other than those with the specified liabilities do not have rights or obligations related to the specified assets or to residual cash flows from those assets. In substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee. Thus, in substance all of the assets, liabilities and equity of that deemed separate entity are economically ringed-fenced from the overall investee. Such a deemed separate entity is often called a 'silo'".*

If an investor controls a "silo" in an investee, it consolidates a portion of an investee as a separate entity. Other parties exclude that portion of the investee when assessing control of and in consolidating the investee.

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1.2.4.5 Reassessment of Control

The MFRS requires that an investor shall reassess whether it controls an investee only if facts and circumstances indicate that there are changes to one or more of the 3 elements of control. This means that if an investor has made a consolidation decision on an investee (whether the latter is a subsidiary or otherwise), that decision cannot be changed subsequently, such as by a change in accounting policy.

A change in power over an investee can occur when there are changes to decision-making rights, for example when the relevant activities are no longer directed through voting rights, but instead by other agreements, such as a contract, that give another party or parties the current ability to direct the relevant activities.

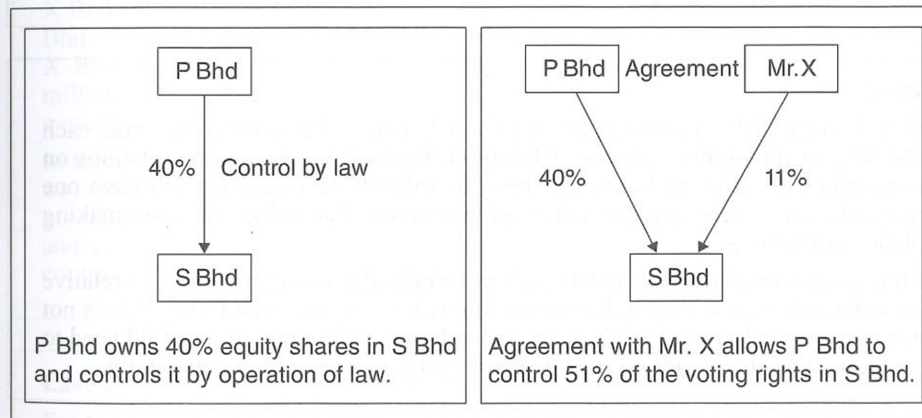
An investor may also gain or lose power over an investee without the investor being involved in that event. For example, an investor can gain power over an investee because decision-making rights held by another party or parties that previously prevented the investor from controlling an investee have lapsed.

Changes to exposure, or rights, to variable returns from its involvement may also cause an investor to lose control of an investee, for example when the investor ceases to be entitled to receive returns or to be exposed to obligations, such as when a contract to receive performance-related fees is terminated.

1.2.5 Examples on Application of the New Control Model in MFRS 10

1.2.5.1 Control by Operation of Law or by Agreement with Other Investors

The following group structures illustrate how control exists when the equity interest is not more than 50%, but the power to direct is obtained by operation of law or by agreement with other investors that allows the investor to have more than a majority of the voting rights.



P Bhd owns 40% equity shares in S Bhd and controls it by operation of law.

Agreement with Mr. X allows P Bhd to control 51% of the voting rights in S Bhd.

1.2.5.2 Control by Holding Sufficient Voting Rights

The following cases illustrate how to assess whether an investor has sufficient voting rights to have the power to direct the relevant activities of an investee (ie the application of the dominant shareholder concept).

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Cases on Investor's Voting Rights that Are 50% or Less

Case 1

Entity P holds 40% of the ordinary shares of Entity Q. The next two largest shareholdings of Entity Q are 10% and 5%, respectively, and the remaining ordinary shares are held by thousands of shareholders, none individually more than 1%. None of the shareholders has any arrangement to consult each other or to make collective decisions.

In this case, on the basis of the absolute size of its holding and the relative size of the holdings of other shareholders, Entity P has sufficient dominant voting rights to meet the power criterion without the need to consider any other evidence of power.

Case 2

Entity P holds 30% of the ordinary shares of Entity Q and 7 other shareholders each hold 10% of the ordinary shares of Entity Q. A shareholder agreement between Entity P and all the other shareholders grants Entity P the right to appoint, remove and set the compensation of management responsible for the relevant activities of Entity Q. However, Entity P has yet to exercise this right and chooses to remain as a passive investor.

In this case, considering the absolute size of its holding and the relative size of the other shareholdings alone is not conclusive to determine that Entity P has rights sufficient to give it power over Entity Q. However, the fact that Entity P has the contractual right to appoint, remove and set the compensation of key management is sufficient to conclude that Entity P has power. The fact that Entity P has not exercised this right yet or the likelihood of it exercising this right should not be considered when assessing if it has the power.

Case 3

Entity P holds 40% of the ordinary shares of Entity Q. Three other investors each hold 20% of the ordinary shares of Entity Q. Entity P has two representations on the board of directors of Entity Q whilst the other three investors each have one representation. There are no other arrangements that affect decision-making policies of Entity Q.

In this case, considering the absolute size of Entity P's voting right and its relative size to the other three shareholdings is sufficient to conclude that Entity P does not have power over Entity Q. This is because only three other investors would need to cooperate to be able to prevent Entity P from controlling Entity Q unilaterally.

Case 4

Entity P holds 40% of the ordinary shares of Entity Q. Twelve other investors each hold 5% of the ordinary shares of Entity Q. None of the other shareholders has any contractual arrangement to consult each other or to make collective decisions.

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In this case, considering the absolute size of Entity P's holding and the relative size of the other shareholdings alone is not conclusive to determine if Entity P has rights sufficient to give it power over Entity Q. Additional facts and circumstances that indicate that Entity P has or does not have power should be considered. For example, if the fact pattern indicates that half of the 12 other investors consistently did not attend shareholders' meetings in the past, Entity P may conclude that it would be able to exercise more than half of the voting rights in Entity's Q's shareholders' meetings and thus meets the power element in the control model.

1.2.5.3 Potential Voting Rights

An entity may hold warrants, share options or convertible securities that are exercisable or convertible into ordinary shares or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the financial and operating policies of another entity (*potential voting rights*). The MFRS requires that the existence and effects of potential voting rights, including potential voting rights held by another entity, are considered when assessing whether an entity has the power to direct the relevant activities of an investee. In assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances (including the terms of the exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential voting rights, except the intention of management and the financial ability to exercise or convert. The condition of "currently exercisable" in the former MFRS 127 has been removed.

Case 1 – Potential voting rights are in the money

X Bhd and Y Bhd each holds a 30% interest in the 100 million ordinary shares of S Bhd. The remaining shareholders are spread out evenly among the public investors. X Bhd also holds 50 million warrants of S Bhd, which are exercisable into 50 million new ordinary shares of S Bhd. The exercise price of the warrants is currently in the money.

In this case, if X Bhd were to exercise the warrants it holds in S Bhd, its effective ownership in S Bhd would be [30m + 50m]/[100m + 50m] = 53.3%. This would give X Bhd a voting power of more than half. Thus, with the potential voting rights and considering all other relevant factors, it is probable that X Bhd would have control of S Bhd, and should therefore treat S Bhd as a subsidiary.

Case 2 – Potential voting rights that are not substantive

Entity A and Entity B currently hold 60% and 40%, respectively, of the voting ordinary shares of Entity C. However, Entity B has a call option to acquire half of Entity A's voting ordinary shares of Entity C. The option is exercisable at any time in the next 3 years at a fixed price that is deeply out of the money (and is expected to remain so for that 3-year period). Entity A has been exercising its votes and is actively directing the relevant activities of Entity C.

2.3.2 Intragroup Construction of Real Estate

An entity in a group may be a property developer and constructs real estates for sales to third parties as well as to other entities in the same group. Any such intragroup sales of real estates shall be accounted for in the same manner as sales of inventories (real estates) by the seller and treated as property plant and equipment by the buyer. Within a group, the transaction is akin to a self-constructed PPE.

To the selling entity, revenue and cost of sales are recognised over time by reference to the stage of completion at the end of each reporting period. To the buying entity, it shall initially recognise a capital work-in-progress until the construction of the real estate is completed, which would then be transferred to an appropriate class of PPE. At the group level, the intragroup revenue and cost of sales shall be eliminated so that the carrying amount of the capital work-in-progress reverts to the original cost of construction to the group. Upon completion of the real estate, the carrying amount of the PPE would be the group's cost of construction. The unrealised profit eliminated on consolidation would be realised through depreciation adjustments over the useful life of the PPE.

Example 2.7

Bina Developer Bhd constructs real estates for sales to customers. In January 20x1, it commenced construction of a high-rise office building for sale to its subsidiary. The sale and purchase price for the office building was RM100 million. The estimated cost of construction was RM60 million. The construction took 2 years to complete. Bina Developer Bhd recognised revenue and cost of sales over the 2-year period (each ended 31 December) as follows:

	20x1	20x2
	RM'000	**RM'000**
Revenue	60,000	40,000
Cost of sales	(36,000)	(24,000)
Profit	24,000	16,000

Income tax rate was 24%. The property had a useful life of 50 years and depreciation was on the straight-line basis.

Required

(a) Show the journal entries required at the consolidation level to eliminate the intragroup transaction and unrealised profits.

(b) Explain and show how the unrealised profit would be realised subsequently.

Solution 2.7

(a) The consolidation adjustments are as follows:

For the year ended 31 December 20x1:

	RM'000	RM'000
Dr Revenue	60,000	
Cr Cost of sales		36,000
Cr Capital work-in- progress		24,000
- To eliminate intragroup sale and unrealised profit.		
Dr Deferred tax asset (24% × 24,000)	5,760	
Cr Deferred tax income in profit or loss		5,760
- To account for the tax effect of unrealised profit.		

For the year ended 31 December 20x2:

Dr Revenue	40,000	
Cr Cost of sales		24,000
Cr Capital work-in-progress		16,000
- To eliminate intragroup sale and unrealised profit.		
Dr Deferred tax asset (24% × 16,000)	3,840	
Cr Deferred tax income in profit or loss		3,840
- To account for the tax effect of unrealised profit.		

(b) Upon completion, the capital work-in-progress transferred to property, plant and equipment would be as follows:

	RM'000
Cost per the subsidiary's books	100,000
Less: Unrealised profit	(40,000)
Cost to the Group	60,000

The unrealised profit of RM40 million will be realised evenly over 50 years (beginning in the year 20x3) by the following yearly adjustments:

	RM'000	RM'000
Dr Accumulated depreciation	800	
Cr Depreciation expense		800
- To correct for the depreciation over-provided.		
Dr Deferred tax expense	192	
Cr Deferred tax asset		192
- To account for the related tax effect.		

2.3.3 Transfers of PPE

When PPE are transferred amongst member entities at their net book values (original costs and accumulated deprecations), no subsequent adjustment is required on consolidation as within the group there has, in effect, been no change in PPE, insofar as those transfers are concerned.

However, if such transfers are not made at book values, the following effects may occur:

(a) the disposing entity may record a profit or loss on such transfer; and

(b) the transfer price is treated as cost by the purchasing entity and accordingly, depreciation is provided on such transfer value.

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Thus, on consolidation, we need to eliminate the intragroup profit or loss on the transfers of PPE and to correct the depreciation over- or under-provided, so that the effects would be to make it as if the transfer had been made at book values.

A further complication arises if the purchasing entity depreciates the PPE as if they were new. This has the effect of extending the previously assessed useful lives of the PPE from the group's viewpoint. Thus, should the consolidation adjustments be made on the basis of the previously assessed useful lives or on the basis of the useful lives used by the purchasing entity? Conceptually, the assets transferred should be depreciated over their remaining useful lives. Therefore, either basis may be acceptable depending on which accords more closely to the remaining useful lives of the PPE.

Example 2.8

On 1 January 20x2, Parent Bhd transferred one machine from its PPE to Sons Bhd at a transfer price of RM400,000. The original cost of the machine was RM500,000, and the accumulated depreciation at the date of transfer was RM200,000.

It is the policy of the group to depreciate such machinery at 20% on cost per annum, charging a full year's provision in the year of purchase and none in the year of disposal. Sons Bhd treated the transfer price as cost and depreciated it at the 20% rate.

Required

Show the consolidation eliminations and adjustments in respect of the above transfer of PPE using:

(i) the previously assessed useful life, and

(ii) the newly assessed useful life

Ignore tax effects. Also, provide a summary of the adjustments made.

Explanation

The depreciation provided each year by Sons Bhd was RM80,000 (ie 20% × RM400,000). After eliminating the unrealised profit and reinstating the original cost and accumulated depreciation, the net book value will revert to the value before transfer of RM300,000. If basis (i) is used, the depreciation per year over the remaining 3-year life is RM100,000. Thus, for the first 3 years, there will be depreciation under-provided by RM20,000 a year, and in the next 2 years, depreciation will be over-provided by RM80,000 per year (the whole depreciation of Sons Bhd, because the asset is fully depreciated by then, from the group's viewpoint).

If basis (ii) is used instead, the RM300,000 net book value will be depreciated at RM60,000 over a revised remaining life of 5 years (as per the life used by Sons Bhd). Thus, from the group's viewpoint, the yearly depreciation of Sons Bhd will be over-provided by RM20,000 a year for the 5-year period.

In either basis, the RM100,000 unrealised profit will eventually be realised after 5 years.

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Solution 2.8

Irrespective of the basis used, the first adjustment is to eliminate the unrealised profit and to reinstate the cost and accumulated depreciation, as follows:

Year 20x2	RM'000	RM'000
Dr Property, plant and equipment, at cost	100	
Dr Gain on sale of property, plant and equipment	100	
Cr Accumulated depreciation		200

- to eliminate intragroup profit and to reinstate cost and accumulated depreciation of property, plant and equipment transferred

Depreciation adjustments:		Basis (i)		Basis (ii)	
		RM'000	RM'000	RM'000	RM'000
		Dr	**Cr**	**Dr**	**Cr**
Year					
20x2	Depreciation expense	20			20
	Accumulated depreciation		20	20	
20x3	Depreciation expense	20			20
	Accumulated depreciation		20	20	
20x4	Depreciation expense	20			20
	Accumulated depreciation		20	20	
20x5	Depreciation expense		80		20
	Accumulated depreciation	80		20	
20x6	Depreciation expense		80		20
	Accumulated depreciation	80		20	

Summary of Adjustments

Year		Basis (i)	Basis (ii)
20x2	Full profit elimination	(100)	(100)
	Realisation:		
20x2	Depreciation adjustment	(20)	20
20x3	”	(20)	20
20x4	”	(20)	20
20x5	”	80	20
20x6	”	80	20
		100	100

2.4 Intragroup Sales or Transfers of Intangible Assets

In MFRS 138 *Intangible Assets*, other than development expenditures arising from research and development activities, internally generated intangible assets, such as brand names, trade names and customer lists, are not recognised. Acquired intangible assets, including those arising from business combinations, are recognised separately.

If there are intragroup sales or transfers of intangible assets, the elimination principles discussed for intragroup sales or transfers of PPE above apply equally. The gain (or loss) arising from the intragroup transaction shall be eliminated on consolidation. The unrealised gain is subsequently realised through use by adjustments to the amortisation expenses over the remaining useful life of the intangible asset. These consolidation adjustments apply even if the sale or transfer involves an unrecognised intangible asset of the seller.

Example 2.9

P Bhd has numerous valuable brand names that are internally developed and are unrecognised in its financial statements. On 1 January 20x8, it sells a brand name (Branco biscuits brand) to its wholly-owned subsidiary, S Sdn Bhd, for a cash consideration of RM10 million. P Bhd recognises a gain of RM10 million in its profit or loss. S Sdn Bhd records the acquired brand name at cost of RM10 million and amortises the intangible asset on the straight-line basis over a useful life of 5 years. Income tax rate is 24%.

In P Bhd's separate financial statements, P Bhd records the sale as follows:

	RM'000	RM'000
Dr Cash	10,000	
Cr Gain in profit or loss		10,000
- to recognise gain on sale of brand name in profit or loss.		
Dr Current tax expense	2,400	
Cr Current tax liability		2,400
- to recognise current tax effect.		

The consolidation adjustments in the year of sale are as follows:

	RM'000	RM'000
Dr Parent's gain on sale of brand name	10,000	
Cr Intangible asset – brand name		10,000
- to eliminate gain and brand name.		
[Note: At the group level, the brand name remains unrecognised]		
Dr Deferred tax asset	2,400	
Cr Deferred tax expense		2,400
- to recognise the tax effect of unrealised profit.		

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The yearly adjustments for amortisation expense over 5 years would be as follows:

	RM'000	RM'000
Dr Accumulated amortisation in financial position	2,000	
Cr Amortisation expense in profit or loss		2,000
- to eliminate amortisation expense.		
Dr Deferred tax expense	480	
Cr Deferred tax asset		480
- to recognise tax effect of amortisation expense.		

2.5 Intragroup Leases of PPE and Investment Property

This section deals with group accounting issues in intragroup lease arrangements. MFRS 16 *Leases* applies a right-of-use model to require a lessee to recognise a right-of-use asset and a corresponding lease liability for all lease arrangements as there is no distinction between financial leases and operating leases. However, for lessor accounting, MFRS 16 retains the risks and rewards approach of the former MFRS 117 *Leases* in classifying a lease arrangement as a finance lease or an operating lease. The new MFRS applies to intragroup lease arrangements in the separate financial statements of a parent and in the individual financial statements of the subsidiaries. It applies equally to a group as a single economic entity, and hence, all intragroup lease arrangements are intragroup transactions and must be eliminated on consolidation in accordance with MFRS 10 *Consolidated Financial Statements*. The group accounting issues are mainly on the consolidation adjustments required.

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2.5.1 Intragroup Leases of Lands

For strategic reasons, a group may designate a particular group-entity to acquire lands and subsequently leases the lands to other group-entities who would undertake the intended business operations of the group, such as property development, cultivation of plantation crops, etc.

2.5.1.1 Treated as a Finance Lease by Lessor

If the intragroup land-lease arrangement is classified as a finance lease, the accounting treatments in the lessor's and the lessee's financial statements are symmetrical. The lessor derecognises the underlying land and recognises a lease receivable (an intragroup receivable) whilst the lessee recognises the underlying land as a right-of-use asset and a corresponding lease liability (an intragroup payable).

On consolidation, the intragroup transactions, lease receivable and lease liability are eliminated, and the right-of-use asset is reclassified as land (a PPE item) in the consolidated statement of financial position. Similarly, the interest income on lease receivable and the interest expense on the lease liability are eliminated on consolidation in the consolidated statement of comprehensive income.

Year	Lease Liability				Right of Use Asset	
	Opening balance RM'000	Interest expense RM'000	Lease payment RM'000	Closing balance RM'000	Depreciation RM'000	Carring amount RM'000
3	3,231.61	161.58	(500.00)	2,893.19	386.09	2,702.61
4	2,893.19	144.66	(500.00)	2,537.85	386.09	2,316.52
5	2,537.85	126.89	(500.00)	2,164.74	386.09	1,930.43
6	2,164.74	108.24	(500.00)	1,772.98	386.09	1,544.35
7	1,772.98	88.65	(500.00)	1,361.62	386.09	1,158.26
8	1,361.62	68.08	(500.00)	929.71	386.09	772.17
9	929.71	46.49	(500.00)	476.19	386.09	386.09
10	476.19	23.81	(500.00)	(0.00)	386.09	(0.00)
Total		1,139.13	(5,000.00)		3,860.87	

In the consolidated financial statements, these are intragroup balances and transactions and shall be eliminated. The consolidation adjustments for Year 1 would be as follows:

	RM'000	RM'000
Year 1:		
Dr Lease liability – lessee	3,553.91	
Dr Rental income – lessor	500.00	
Cr Right-of-use asset – lessee		3,474.78
Cr Interest expense – lessee		193.04
Cr Depreciation expense – lessee		386.09

- to eliminate intragroup lease balances and transactions.

At the group level, the underlying asset in the lease remains as a freehold land with a carrying amount of RM10 million in the consolidated statement of financial position.

2.5.2 Different Functions or Uses of Intragroup Leased Property

In the former MFRS 117, a lessor in an intragroup lease of property may treat the underlying property as an investment property and measure it at fair value through profit or loss in accordance with MFRS 140 *Investment Property*. If the lessee in an operating lease uses the property for its operations, the group shall present the underlying asset as a class of PPE rather than as an investment property because the function of the property to the group is for owner-occupation. If the group's policy is to measure this class of PPE at the cost model, the investment property in the accounts of the lessor shall be reclassified to PPE in the consolidated statement of financial position and the fair value gains or losses shall be eliminated and replaced with depreciation and impairment, if any, of the PPE by consolidation adjustments. The respective rental income and rental expense shall also be eliminated at the group level.

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Applying MFRS 16 to such arrangement would require that the lessee recognises a right-of-use asset and a corresponding lease liability in its individual financial statements. Thus, the underlying property in the lease classified by function would be different in the individual financial statements of the lessor, the lessee and the group as a whole. For example, the lessor may classify the underlying property as investment property and measure it at fair value through profit or loss, the lessee has to classify the right-of-use asset and measure it at cost less depreciation, whilst the group has to treat the property as owner-occupied PPE based on use or function to the group. Thus, on consolidation, the treatments accorded by the lessor and the lessee have to be adjusted and amended to reflect the underlying asset in the lease as an owner-occupied property and accounted for in accordance with MFRS 116 *Property, Plant and Equipment.*

Example 2.12

Five years ago, P Bhd set up a wholly-owned subsidiary, S Bhd, with a paid-up capital of RM50 million. On 1 January 20x1, P Bhd acquired a property with a cost of RM100 million. The property was classified as an investment property measured at fair value through profit or loss in accordance with MFRS 140 *Investment Property*. On the same day, P Bhd leased the property to S Bhd for a lease term of 4 years. S Bhd used the property for its operations. The lease payment per year was RM6 million.

At the commencement date of the lease, S Bhd's borrowing cost was 6.5% per annum. Over the 4-year lease term, the lease liability and the right-of-use asset in the accounts of S Bhd are as follows:

Year	Lease Liability				Right of Use Asset	
	Opening balance RM'000	Interest expense RM'000	Lease payment RM'000	Closing balance RM'000	Depreciation RM'000	Carring amount RM'000
0				20,554.79		20,554.79
1	20,554.79	1,336.06	(6,000.00)	15,890.85	5,138.70	15,416.09
2	15,890.85	1,032.91	(6,000.00)	10,923.76	5,138.70	10,277.40
3	10,923.76	710.04	(6,000.00)	5,633.80	5,138.70	5,138.70
4	5,633.80	366.20	(6,000.00)	–	5,138.70	–
		3,445.21	(24,000.00)		20,554.79	

At 31 December 20x1, the market value of the property was RM105 million. P Bhd recognised a fair value gain of RM 5 million in its profit or loss. The property has a useful life of 50 years.

The summarised financial statements of the 2 companies for the current year ended 31 December 20x1 are as follows:

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Example 3.12

On 1 January 20x7, Mamba Bhd acquired a 75% interest in the equity capital of Samba Bhd for a consideration of RM175 million. On this date, the identifiable assets, liabilities and contingent liabilities of Samba Bhd were provisionally valued as follows:

	RM'000
Tangible assets	280,000
Technology-based intangible asset	60,000
Liabilities	(30,000)
Contingent liabilities	(10,000)
Net assets at 1 January 20x7	300,000

The fair value of Samba Bhd as a whole at the acquisition date was initially estimated at RM320 million.

On 31 December 20x7, Mamba Bhd reassessed the recognition and measurement of the fair value of consideration given, and of Samba Bhd's identifiable assets, liabilities and contingent liabilities and concluded that:

(a) based on an income approach to valuation, the fair value of Samba as a whole was equal to the fair value of the identifiable net assets (ie no inherent goodwill).

(b) the fair value of the consideration transferred was understated by RM10 million because a contingent consideration has been excluded in the initial assessment.

(c) termination benefits of RM15 million were payable to certain employees conditional on Samba being acquired in a business combination. This amount has not been included in the net assets at the acquisition date.

(d) the fair value ascribed to a landed depreciable property of Samba Bhd was considered to be overvalued by RM5 million.

(e) based on the discounted cash flow method, the technology-based intangible asset was assessed to have a fair value of RM56 million.

(f) an amount of RM20 million was needed to restructure certain operations and activities of Samba Bhd after the acquisition. This amount has used in the negotiation between the parties to the combination but has not been included in the net assets at the acquisition date.

Income tax rate was 24% and it applied to recognition and measurement of net assets acquired in business combinations.

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Required

(a) Compute the bargain purchase arising on the business combination;

(b) Recompute the difference based on the subsequent assessment of the net assets of Samba Bhd on 31 December 20x7 and explain how it should be dealt with in accordance with the revised MFRS 3. Also, show the consolidation adjustments after the reassessment.

Solution 3.12

(a) Bargain purchase on combination (1 January 2017):

	RM'000
Consideration transferred	175,000
Fair value of non-controlling interest 25% × 320m	80,000
Aggregate	255,000
Fair value of identifiable assets and liabilities	300,000
Bargain purchase – initial assessment	45,000

(b) Review and Remeasurement (31 December 20x7):

	RM'000
Consideration transferred – remeasurement	185,000
Fair value of non-controlling interest 25% × 281,760	70,440
Aggregate	255,440
Net assets at acquisition date – initial assessment	300,000
Termination benefit liability	(15,000)
Deferred tax asset 24% × 15,000	3,600
Adjustment for over-valuation of property	(5,000)
Tax effect at 24% × 5,000	1,200
Adjustment for over-valuation of intangible asset	(4,000)
Tax effect at 24% × 4,000	960
Net assets at acquisition date – reassessment	281,760
Bargain purchase as gain in profit or loss	26,320

This remaining excess shall be recognised as a gain on combination in profit or loss and attributed to the acquirer only. The costs that would be incurred in the restructuring in the post-acquisition period should be recognised as an expense in the period in which the restructuring occurs. In this case, it may be argued that the bargain purchase was obtained in the negotiation due to the need for restructuring the acquiree's operations in the post-acquisition period.

Assuming that the necessary corrections have been made in the respective accounts of the acquirer and the acquiree, the consolidation adjustments would be as follows:

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3.6.2 Step-Acquisition: Requirements in MFRS 3

3.6.2.1 Fair Valuing Previously Held Stake

MFRS 3 requires that in a business combination achieved in stages, the cost of combination shall include any equity interest in the acquiree that the acquirer owned immediately before the acquisition date. It further requires that the acquirer shall remeasure its previously held equity interest in the acquiree at fair value as of the acquisition date. Consequently, any gain or loss arising on the remeasurement of the previously held equity investment shall be recognised in profit or loss.

For example, if the equity interest immediately before the acquisition date was an associate carried in accordance with MFRS 128 (cost plus share of post-acquisition reserves), that carrying amount shall be remeasured to fair value at the acquisition date, and any difference shall be recognised as gain or loss in profit or loss. Similarly, if the previously held equity interest was a financial asset measured at cost because its fair value then could not be measured reliably, that cost carrying amount shall be remeasured to its fair value at the acquisition date and any difference shall be recognised in profit or loss.

Under MFRS 3, when there are previously held equity interests at the date control is obtained, the goodwill on combination is calculated as the excess of (a) over (b) below:

(a) the aggregate of:

  (i) the fair value of the consideration transferred;

  (ii) the amount of any NCI in the acquiree measured at fair value **or** at the NCI's share of net asset; and

  (iii) the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of identifiable assets acquired and the liabilities assumed.

Thus, instead of a step-by-step comparison of cost of purchase with share of net assets (under MPERS or the original MFRS 3) to determine goodwill on each step, the goodwill on combination under the MFRS 3 is calculated only once, ie at the date control is obtained and this may include NCI's share of goodwill.

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Example 3.17

H Bhd made the following purchases of equity shares in S Bhd:

	Number of shares	Cost	Balance in retained profits
	'000	**RM'000**	**RM'000**
1 January 20x1	10,000	15,000	20,000
1 January 20x2	15,000	40,000	30,000
1 January 20x3	30,000	75,000	50,000
	55,000	130,000	

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The summarised statements of financial position of the 2 companies for the current year ended 31 December 20x3 are as follows:

	H Bhd	S Bhd
	RM'000	**RM'000**
Property, plant and equipment	200,000	100,000
Investment in S Bhd	130,000	–
Current assets	70,000	150,000
	400,000	250,000
Ordinary shares, issued at RM1 each	200,000	100,000
Retained profits	120,000	80,000
Non-current liabilities	40,000	20,000
Current liabilities	40,000	50,000
	400,000	250,000

In the prior financial years, H Bhd had no influence in S Bhd and the investment in S Bhd was measured at cost because its fair value then could not be measured reliably. On 1 January 20x3, H Bhd assumed control of S Bhd.

It is the policy of the group to measure NCI at acquisition-date fair value. On 1 January 20x3, the fair value of the ordinary shares of S Bhd was RM2.50 per share.

Required

(a) Compute the goodwill on combination under the:

  (i) MPERS Framework.

  (ii) MFRS 3 (with NCI measured at acquisition-date fair value).

(b) Prepare the consolidated statement of financial position under each of the above standards.

Solution 3.17

(a) Goodwill on combination

  (i) Under the MPERS Framework:

	1 January 20x1	1 January 20x2	1 January 20x3	Total
	RM'000	**RM'000**	**RM'000**	**RM'000**
Cost of purchase (a)	15,000	40,000	75,000	
Share of net assets:				
Share capital	100,000	100,000	100,000	
Pre-acquisition profits	20,000	30,000	50,000	
Net assets	120,000	130,000	150,000	
Per cent stake	10%	15%	30%	

Example 3.20

The issued share capital of Jaya Bhd consists of 10,000,000 ordinary shares issued at RM1.00 each. Prior to the current year ended 31 December 20x3, Maju Bhd made the following purchases of shares in Jaya Bhd.

Date	Shares acquired	Cost of shares	Balance in Jaya's retained profits
	RM'000	**RM'000**	**RM'000**
1 January 20x1	1,000	1,600	4,000
1 January 20x2	2,000	3,600	6,000

On 1 January 20x3, Maju Bhd purchased another 1,500,000 shares of Jaya Bhd from the open market at a total cost of RM3,750,000. This purchase triggered the 33% mandatory takeover provision of the Code, as a result of which Maju Bhd made a general offer to the remaining shareholders of Jaya Bhd at RM3.20 a share. Approval was obtained from the relevant authorities and shareholders. Acceptance of the offer was finalised on 30 June 20x3 and the shareholders of Jaya Bhd who held 1,500,000 shares accepted the offer at the cash price of RM3.20 per share. This was duly paid by Maju Bhd on 1 July 20x3.

The summarised draft accounts of the 2 companies for the current year ended 31 December 20x3 are as follows:

Statements of Profit or Loss and Other Comprehensive Income

	Maju Bhd	Jaya Bhd
	RM'000	**RM'000**
Revenue	80,000	60,000
Operating expenses	(75,800)	(57,860)
Profit from operations	4,200	2,140
Finance cost	(1,000)	(800)
Profit before taxation	3,200	1,340
Taxation	(850)	(350)
Profit after taxation	2,350	990
Other comprehensive income:		
Fair value gain of equity investment	2,250	–
Total comprehensive income	4,600	990

Movements in Retained Profits:

Retained profits brought forward	12,150	8,260
Profit for the year	2,350	990
Retained profits carried forward	14,500	9,250

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Statements of Financial Position

	Maju Bhd	Jaya Bhd
	RM'000	**RM'000**
Share capital, issued at RM1 each	40,000	10,000
Fair value reserve – equity investment	4,550	–
Retained profits	14,500	9,250
	59,050	19,250
Long-term liabilities	12,100	8,550
	71,150	27,800
Property, plant and equipment	37,200	17,400
Equity investment		
6,000,000 shares in Jaya Bhd	18,300	–
Net current assets	15,650	10,400
	71,150	27,800

Additional information:

In the prior financial years, Maju Bhd did not have significant influence over Jaya Bhd. The investment in Jaya Bhd was classified as an equity investment measured at fair value through other comprehensive income. Changes in fair value of this investment up to 30 June 20x3 have been recognised in other comprehensive income and retained in a fair value reserve. It has not reclassified the fair value reserve to retained profits in equity.

On 30 June 20x3, a property of Jaya Bhd, recorded in the accounts at RM8,000,000 was valued on the open market basis at RM10,000,000. This property had a remaining useful life of 20 years. No adjustment has been made in its account to reflect this fair value. Also, an identifiable customer-based intangible asset, valued at RM6,000,000, was not recorded in the accounts of Jaya Bhd. The estimated useful life of this intangible asset was 20 years.

As at 30 June 20x3, the ordinary shares of Jaya Bhd closed at RM3.00 per share. The fair value of Jaya Bhd as a whole was based on its closing market price on the acquisition date. Income tax rate was 25%.

Required

(a) Calculate the goodwill on combination in accordance with MFRS 3. Allocate the goodwill between the parent and the NCI. Also, indicate any control premium.

(b) Calculate the gain or loss on remeasurement of the previously held equity investment immediately before the acquisition date.

(c) Produce the consolidated financial statements of Maju Bhd for the 20x3 financial year.

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5.1 Background to IFRS 11 and the Revised IAS 28

5.1.1 IASB's Reasons for Issuing IFRS 11 Joint Arrangements

Accounting for interests in joint ventures and strategic alliances through joint control was previously covered in the former IAS 31 *Interests in Joint Ventures*. The first version of the former IAS 31 was issued by the then IASC in December 1990, a revised version was issued by the IASB in December 2003, and in between then and the current IFRS 11, there were amendments made for improvements.

A conceptual weakness in the former IAS 31 was that the accounting for joint ventures was primarily driven by the structure of an arrangement, ie the form of the structure was the only determinant of the accounting, not the substance of the arrangement. For example, investment in a joint venture company (a legal separate vehicle) would automatically be classified as a joint venture in its legal form.

For joint ventures that were structured through legal entities, the former IAS gave a choice of accounting, using either the equity method or the proportionate consolidation method. Outreach activities and research work done by the IASB revealed that about half the preparers with an interest in a jointly controlled entity apply the equity method, with the other half applying the proportionate consolidation method. This diversity in practice could potentially compromise the enhancing qualitative characteristic of comparability.

The rationale of IFRS 11 is based on the view that if an entity has rights to assets and obligations incurred in a joint arrangement, it shall account for those rights and obligations directly. In contrast, if an entity has rights only to the net assets of a joint arrangement, it shall account for its share of the net assets directly (implying the use of the equity method in this latter case). The change in approach is necessary to reflect more accurately the substance of an entity's involvement in joint arrangements.

5.1.2 The Salient Features of IFRS 11

Joint arrangements can be structured in various forms, ranging from jointly controlled assets, jointly controlled operations, joint venture entities (legal entities or otherwise) and strategic alliances of businesses. A key feature of IFRS 11 is that the accounting for joint arrangements focuses on the economic substance of an arrangement. It uses a ''rights and obligations'' approach in which parties to an arrangement recognise their rights and obligations arising from the arrangement. It is thus a principle-based standard that provides for consistency in the accounting that would enhance comparability of financial statements.

The criteria of joint control remain largely the same as the former IAS 31 but with added clarification that the sharing of control is based on decisions about the relevant activities (relying on those developed in IFRS 10 *Consolidated Financial Statements*).

IFRS 11 distinguishes 2 types of joint arrangements, ie either joint venture or joint operation. A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have *rights to the net assets* of the arrangement. A party having joint control in such an arrangement is known as a joint venturer. In contrast, a joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have *rights to the assets*, and *obligations for liabilities*, relating to the arrangement. A party having joint control in such an arrangement is known as a joint operator.

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If the arrangement is a joint operation, a joint operator accounts for the assets, liabilities, revenues and expenses related to its interest in the joint operation in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses [IFRS 11.20]. These may include share of any assets held jointly and share of any liabilities incurred jointly.

If the arrangement is a joint venture, a joint venturer recognises its interest in the joint venture as an investment and accounts for that investment using the equity method (referenced to the revised IAS 28) [IFRS 11.24]. The proportionate consolidation is disallowed in such joint arrangement.

The accounting treatment would thus depend on the classification of the joint arrangement, ie whether it is a joint operation or a joint venture. This classification is determined by assessing the rights and obligations of the parties arising from the particular arrangement [see IFRS 11.14].

A separate vehicle may be created in a joint arrangement. The Standard defines a separate vehicle as a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

Typically, if a joint arrangement is not structured through a separate vehicle, it would be classified as a joint operation in this IFRS. A joint operator accounts directly for the assets, liabilities, revenues and expenses related to the joint operation.

However, if a joint arrangement is structured through a separate vehicle, a reporting entity needs to consider the legal form and the terms of the contractual arrangement, and if relevant, other facts and circumstances to determine whether the arrangement is a joint operation or a joint venture [IFRS 11.17].

This requirement means that even if the arrangement takes the form of a legal separate entity (such as a registered company), it is not necessarily classified as a joint venture. If the assessment determines that the arrangement through a separate vehicle is a joint operation, the operator would still need to account for its share of the respective assets, liabilities, revenues and expenses (based on its rights and obligations) in the separate vehicle. In this respect, the accounting treatment is similar to the proportionate consolidation of the former IAS 31, albeit on a slightly different basis. When applying the proportionate consolidation, the former IAS required a line-by-line constant per cent addition of the line items in the financial statements. This new IFRS requires addition of each line item in the financial statements based on the operator's rights to an asset item or obligation incurred on a liability item.

5.1.3 IAS 28 (Revised) Investments in Associates and Joint Ventures

The revised IAS 28 incorporates the requirement to apply the equity method for joint arrangements classified as joint ventures in accordance with IFRS 11. Apart from this semantic change, there are no other significant changes to the requirements for the equity method for investments in joint ventures or associates. Some additional guidance is provided on discontinuation of the equity method when there is a loss of joint control or significant influence.

5.2 Principles of Investments in Joint Arrangements

Criterion of Joint Control

A joint arrangement is defined in MFRS 11 as an arrangement of which 2 or more parties have joint control. The central criterion for distinguishing joint arrangements from subsidiaries and associates is the existence of joint control. The Standard defines *joint control* as ''the contractually agreed sharing of control of an arrangement, which exists only when the decisions about the relevant activities require the unanimous consent of the parties sharing control''.

Joint arrangements may take different forms and structures. The Standard specifies that a joint arrangement may be either a joint operation or a joint venture.

What Is a Joint Operation?

A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities, relating to the arrangement. A joint operator is a party to a joint operation that has joint control of that operation. An example of a joint operation is when 2 or more joint operators combine their operations, resources and expertise in order to produce, market and distribute jointly a particular product, such as an aircraft or a ship. Another example of a joint operation is when 2 or more oil and gas joint operators jointly own, control and operate an oil pipeline. Each joint operator uses the pipeline to transport its own products in return for which it bears an agreed proportion of the expenses of operating the pipeline.

What Is a Joint Venture?

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. A joint venturer is a party to a joint venture that has joint control of that joint venture. A joint venture usually involves the establishment of a corporation, partnership or other economic entity in which each joint venturer has an ownership interest. The entity is, however, jointly controlled by the joint venturers, and this is usually specified in its articles or by-laws.

Note that in the case of a 2-party joint venture, it is not necessary that the joint venturers must have equal equity stake in the joint venture for joint control to exist. For example, one joint venturer may hold a 60% stake whilst the other joint venturer may hold a 40% stake, the joint venture is established as long as the contractual arrangement provides for both joint venturers to have joint control.

Two Common Characteristics

Despite the diverse forms and structures, all joint arrangements have 2 characteristics in common, and they are:

(a) The parties are bound by a contractual arrangement; and

(b) The contractual arrangement gives 2 or more of those parties joint control of the arrangement [MFRS 11.5].

The first characteristic of contractual arrangement is usually (though not necessarily) evidenced in writing, for example, by a formal contract amongst the parties or by the articles or by-laws of the joint arrangement. Statutory mechanism can also create enforceable arrangements, either on their own or in conjunction with contracts between

the parties. When the arrangements are structured through a *separate vehicle*, the contractual arrangement, or some aspects of the contractual arrangement, will in some cases be incorporated in the articles, charters or by-laws of the separate vehicle.

The contractual arrangement sets out the terms upon which the parties participate in the activity that is the subject of the arrangement, and generally deals with such matters as:

(a) the purpose, activity and duration of the joint arrangement;

(b) the appointment of the board of directors or equivalent governing body of the joint arrangement;

(c) the decision-making process: the matters requiring decisions from the parties, the voting rights of the parties and the required level of support for those matters. The decision-making process reflected in the contractual arrangement establishes joint control of the arrangement;

(d) the capital or other contributions required of the parties; and

(e) the sharing by the parties of the output, income, expenses or results of the joint arrangement.

All Parties Must Collectively Control the Arrangement

The second characteristic of joint control requires that no single party is in a position to control unilaterally the joint arrangement. When assessing whether an entity has joint control of an arrangement, the entity shall assess first whether all the parties, or a group of the parties control the arrangement (in accordance with the definition of control in MFRS 10), ie whether all the parties or group of parties are exposed, or have rights, to variable returns from their involvement with the arrangement and have the ability to affect those returns through their power over the arrangement. When all the parties, or a group of parties, considered collectively, are able to direct the activities that significantly affect the returns of the arrangement (ie the relevant activities), the parties control the arrangement collectively.

After concluding that all parties, or a group of parties, control the arrangement collectively, an entity shall assess whether it has joint control of the arrangement. Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that collectively control the arrangement.

If There Is an Explicit Agreement

In a straightforward case, joint control is established when the contractual arrangement *explicitly* provides for decisions about the relevant activities to require the unanimous consent of all parties to the arrangement.

Example 5.1

In a 2-party arrangement, Entity A holds a 70% equity stake and Entity B holds a 30% equity stake, the contractual arrangement requires unanimous consent when making decisions about the relevant activities. In this case, Entity A does not control the arrangement unilaterally because it needs the agreement of Entity B. Another example is when an arrangement in which Entity A and Entity B each has a 35% of the voting rights in the arrangement with the remaining 30% being widely dispersed. Decisions about the relevant activities require approval by a majority of

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the voting rights. Entity A and Entity B have joint control of the arrangement only if the contractual arrangement specifies that decisions about the relevant activities of the arrangement require both Entity A and Entity B agreeing. In the absence of any specification, the arrangement is not a joint arrangement (in which case, both Entity A and Entity B would most likely treat the arrangement as an associate in accordance with MFRS 128).

Implicit Joint Control

The decision-making process that is agreed upon by the parties in their contractual arrangement may *implicitly* lead to joint control.

For example, in a 2-party joint arrangement which each having a 50% voting rights and the contractual arrangement between them specifies that at least 51% of the voting rights are required to make decisions about the relevant activities. In this case, the 2 parties have implicitly agreed that they have joint control of the arrangement because decisions about the relevant activities cannot be made without both parties agreeing.

Proportion of Voting Rights

The contractual arrangement may require a minimum proportion of the voting rights to make decisions about the relevant activities. When that minimum required proportion of the voting rights can be achieved by more than 1 combination of the parties agreeing together, that arrangement is not a joint arrangement unless the contractual arrangement specifies which parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement. However, if only 1 combination is required to achieve the minimum proportion of the voting rights for making decisions about the relevant activities, the arrangement is a joint arrangement.

Example 5.2

Three parties, Entity A, Entity B and Entity C, establish an arrangement. Entity A has 51% of the voting rights in the arrangement, Entity B has 25% and Entity C has 20%. Another investor holds 4% of the voting rights. The contractual arrangement between the 3 parties specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement. There are no other terms.

In this arrangement, even though Entity A holds more than half the voting rights, it does not control the arrangement unilaterally because it needs the agreement of Entity B. The terms of their arrangement requiring at least 75% of the voting rights to make decisions about the relevant activities imply that Entity A and Entity B have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both Entity A and Entity B agreeing. In this case, a single combination is sufficient to achieve the minimum proportion of the voting rights.

Example 5.3

Three parties, Entity A, Entity B and Entity C, establish an arrangement. Entity A has 50% of the voting rights, Entity B and Entity C each has 25% of the voting rights. Their contractual arrangement specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement.

In this arrangement, Entity A does not control the arrangement because it needs the agreement of either Entity B or Entity C to achieve the 75% voting rights for the decision-making process of the relevant activities. There is more than 1 combination of the parties to reach the 75% voting rights for decision-making about the relevant activities. In this case, to be a joint arrangement, the contractual arrangement between the parties would need to specify which combination of the parties is required to agree unanimously to decisions about the relevant activities of the arrangement. In the absence of any specification of the combination of voting rights for decision-making, the arrangement is not a joint arrangement within the scope of MFRS 11, although they collectively control the arrangement.

5.2.1 Accounting Treatment for a Joint Operation

5.2.1.1 Account Directly Based on Rights to Assets and Obligations for Liabilities

MFRS 11 prescribes that a joint operator shall recognise in relation to its interest in a joint operation:

(a) its assets, including its share of any assets held jointly;

(b) its liabilities, including its share of any liabilities incurred jointly;

(c) its revenue from the sale of its share of the output arising from the joint operation;

(d) its share of the revenue from the sale of the output by the joint operation; and

(e) its expenses, including its share of any expenses incurred jointly [MFRS 11.20].

5.2.1.2 Acquisition of an Interest in a Joint Operation that Constitutes a Business

In 2014, the MASB issued *Acquisition of an Interest in a Joint Operation, Amendment to MFRS 11* to amend MFRS 11 so that a joint operator accounting for the acquisition of an interest in a joint operation in which the activity of the joint operation constitutes a business applies the relevant principles on business combinations accounting in MFRS 3 *Business Combinations* and other Standards and discloses the relevant information required by those Standards for business combinations.

The amendment applies to the acquisition of an interest in an existing joint operation as well as to acquisition of an interest in a joint operation on its formation of the business. However, the amendment should not apply if the formation of the joint operation coincides with the formation of the business because no existing business is contributed to the joint operation.

Example 5.4

On 1 January 20x1, Entity A pays RM10 million to a former operator for an interest in a joint operation. Acquisition-related costs amount to RM500,000 and these are paid in cash.

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The joint operation is an unincorporated business. On this date, the assets and liabilities of the joint operation consist of the following:

	RM'000
PPE of manufacturing plant	20,000
Other PPE	10,000
Inventories for use in manufacturing plant	5,000
Other current assets	6,000
	41,000
Loans (used to part-finance purchase of plant)	10,000
Other liabilities	6,000
Capital contributions by joint operators	25,000
	41,000

The joint arrangement provides for Entity A to have rights to 40% of the PPE and inventories of the manufacturing plant and to assume a 40% of the loans taken to part-finance the purchase of the manufacturing plant. The activity of the manufacturing plant constitutes a business as defined in MFRS 3. Entity A is entitled to 40% of the outputs produced by the plant and it bears 40% of the operating costs of the manufacturing plant. Entity A has no rights or obligations relating to the other assets and liabilities of the joint operation.

To administer its interest in the joint operation, Entity A purchases office machinery and equipment for RM2 million, paying RM1 million in cash and the balance financed by a short-term borrowing from a bank.

The fair value of the PPE of the manufacturing plant on 1 January 20x1 is RM25 million. Assume an income tax rate of 25%.

Required

Explain and show how entity A shall account for its interest in the joint operation above.

Solution 5.4

Entity A shall account for its interest in the joint operation as follows:

It records its initial capital contribution as follows

	RM'00	RM'000
Dr Interest in joint operation	10,000	
Cr Cash		10,000
It recognises the acquisition-related costs as an expense:		
Dr Expense in profit or loss	500	
Cr Cash		500

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For its own assets used and liabilities assumed in the joint operation, it records the following:

	RM'000	RM'000
Dr PPE – office machinery and equipment	2,000	
Cr Short-term borrowing		1,000
Cr Cash		1,000

Because the assets and liabilities of the manufacturing plant in the joint operation constitute a business as defined in MFRS 3, Entity A allocates the consideration transferred to the net assets, as follows:

	Book value	Adjustment	Fair value	% share	Share
	RM'000	RM'000	RM'000	(%)	RM'000
PPE of manufacturing plant	20,000	5,000	25,000	40%	10,000
Inventories for use of plant	5,000		5,000	40%	2,000
Loans related to the plant	(10,000)		(10,000)	40%	(4,000)
Deferred tax liability		(1,250)	(1,250)	40%	(500)
Net assets of business at fair value	15,000	3,750	18,750		7,500
Consideration transferred					10,000
Goodwill on acquisition of business					2,500

For its interest in the joint operation, Entity A records the following share of assets and liabilities, including goodwill:

	RM'000	RM'000
Dr PPE – manufacturing plant	10,000	
Dr Inventories	2,000	
Dr Purchased goodwill	2,500	
Cr Loans		4,000
Cr Deferred tax liability		500
Cr Interest in joint operation		10,000

5.2.2 Accounting Treatment for a Joint Venture

MFRS 11 prescribes that a joint venturer shall recognise its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with MFRS 128 *Investments in Associates and Joint Ventures*, unless the entity is exempted from applying the equity method as specified in that Standard [MFRS 11.24].

MPERS used by private entities provides for an accounting policy choice by allowing a venturer to account for all of its interests in jointly controlled entities using 1 of 3 measurement models: (a) the cost model, (b) the equity method or (c) the fair value model [MPERS S15.9].

In MPERS, if the cost model is applied, the venturer measures its investments in jointly controlled entities other than those for which there is a published price quotation at cost less accumulated impairment losses [MPERS S15.10]. A venturer shall measure its investments in jointly controlled entities for which there is a published price quotation using the fair value model [MPERS S15.12].

The measurement attributes in this cost model are mixed as they depend on the availability of quoted prices of the investments. For example, if the investments in jointly controlled entities are quoted in the market, they are measured using the fair value model. Other investments are measured at cost less impairment.

If the fair value model is applied, when an investment in a jointly controlled entity is recognised initially, a venturer shall measure it at transaction price. Transaction price excludes transaction costs [MPERS S15.14]. At each reporting date, a venturer shall measure its investments in jointly controlled entities at fair value, with changes in fair value recognised in profit or loss. A venturer using the fair value model shall use the cost basis for any investment in a jointly controlled entity for which it is impracticable to measure fair value reliably without undue cost or effort [MPERS S15.15]. The measurement attributes of this fair value model are also mixed because when it is impracticable to measure fair value reliably without undue cost or effort, the investment is measured at cost less impairment.

In MPERS, if the equity method is adopted, a venturer applies the requirements of the equity method prescribed for investments in associates. In this case, the option of cost or fair value measurement for some joint venture entities is not available, ie all joint venture entities must be accounted for under the equity method.

5.3 Principles of Investments in Associates

MFRS 128 defines an associate as ''an entity over which the investor has significant influence''. This includes an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

The Criterion of Significant Influence

The test of whether an investment qualifies as an associate is the existence of *significant influence*, which is defined in the Standard as ''the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies''. For significant influence to arise, the investor must normally own substantial equity interest in the investee.

Substantial shareholding is normally taken to mean an interest of 20% or more of the equity shares in the investee. Note that MFRS 128 does not prescribe an upper limit, although in practice, it is normally set at 50%, as any shareholding of more than 50% would normally qualify the investee to be a subsidiary. Thus, if an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee, it is presumed that the investor does have significant influence unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or

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indirectly through subsidiaries, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated.

The 20% to 50% equity interests may be held indirectly, but they must be through subsidiaries if the presumption is to apply. Note that these bright-line percentages of 20 to 50 are used for the presumptions only because the ultimate test for an associate is still the significant influence criterion. Thus, where an investor has more than 20% interest in an investee but is not represented on the latter's board of directors, it is unlikely that significant influence exists. Accordingly, in such a case, the investee is not an associate of the investor. Such cases would be rare in practice, but they can arise in situations where there is a majority owner who precludes the investor from being represented on the board of directors, and most probably due to a hostile relationship between the majority owner and the investor.

MFRS 128 further explains that the existence of significant influence by an investor is usually evidenced by one or more the following:

(a) representation on the board of directors or equivalent governing body of the investee;

(b) participation in the investee's policy-making processes, including participation in decisions about dividends or other distributions;

(c) material transactions between the investor and the investee;

(d) interchange of managerial personnel, or

(e) provision of essential technical information.

Note that in practice, apart from the substantial ownership interest, board representation is normally considered sufficient evidence of significant influence. As long as there is a representation on the board of the investee, for example, a single board seat, the investor is deemed to have significant influence, notwithstanding the fact that the board of the investee may be controlled by another party or that the proceedings in the board may be dominated by other representatives. In the absence of board representation, other evidences of significant influence should be assessed, such as those listed in (b) to (e) above. These other evidences of significant influence are included to prevent abuses, such as when an investor may want to avoid the effects of equity accounting in a loss-making associate, and thus, purposely decline an invitation to the board of the investee, but chooses to participate in the financial and operating policies of the investee by other means.

MFRS 128 further requires that an investor considers the existence and effect of potential voting rights currently exercisable or convertible when assessing whether it has the power to participate in the financial and operating policy decisions of investee. Potential voting rights arise when the investee issues share warrants, share options, convertible debts or other convertible securities. In assessing whether potential voting rights contribute to significant influence, the investor examines all pertinent facts and circumstances, such as the terms of exercise, except the intention of management and the financial ability to exercise or convert.

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8.1 Identifying the Acquirer in a Reverse Acquisition

8.1.1 What Constitutes a Reverse Acquisition

In some business combinations which are effected through share exchanges, the shareholders of the acquiree may gain effective control over the acquirer. These are known as reverse acquisitions, where the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. For example, in a backdoor listing, a private company may arrange to have itself ''acquired'' by a smaller public listed company as a means of obtaining a listing on a Stock Exchange. Although legally the issuing public listed company is regarded as the parent and the private company is regarded as the subsidiary, the legal subsidiary should be identified as the acquirer if it has the power to direct the relevant activities of the legal parent so as to extract returns from its activities.

MFRS 3 clarifies that in such business combinations, the public listed entity is the legal parent because it issued its equity interests, and the private entity is the legal subsidiary because its equity interests were acquired. However, applying the guidance of the acquisition method in the MFRS results in identifying:

(a) the public entity as the acquiree for accounting purposes (the accounting acquiree), and

(b) the private entity as the acquirer for accounting purposes (the accounting acquirer).

The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition, and all of the recognition and measurement principles in the MFRS, including the requirement to recognise goodwill, apply [MFRS 3.B19].

8.1.2 The Accounting Requirements

MFRS 3 explains that reverse acquisition accounting determines the allocation of the cost of the business combination (ie the consideration deemed transferred by the accounting acquirer) as at the acquisition date and does not apply to transactions after the acquisition. In a reverse acquisition, the cost of the business combination is deemed to have been incurred by the legal subsidiary (ie the acquirer for accounting purposes) in the form of equity instruments issued to the shareholders of the legal parent (ie the acquiree for accounting purposes).

In a reverse acquisition, the accounting acquirer (ie the legal subsidiary) usually issues no consideration for the accounting acquiree. Instead, the accounting acquiree (ie the legal parent) usually issues its equity shares to the owners of the accounting acquirer. Accordingly, the acquisition-date fair value of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition. The fair value of the number of equity interests calculated in that way is then used as the fair value of consideration transferred in exchange for the acquiree [MFRS 3.B20].

Therefore, in measuring the cost of combination, we would need to determine the number of equity shares the legal subsidiary would have had to issue to provide the same percentage of ownership interest of the combined entity to the shareholders of the legal parent as they have in the combined entity as a result of the reverse acquisition. The fair value of the number of equity shares so determined shall be used as the deemed cost of combination.

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The MFRS requires that the consolidated financial statements prepared following a reverse acquisition shall be issued in the name of the legal parent, but described in the notes as a continuation of the financial statements of the legal subsidiary (ie the acquirer for accounting purposes).

Although the consolidated financial statements prepared following a reverse acquisition represent a continuation of the legal subsidiary (ie the accounting acquirer), there is one adjustment necessary to reflect the legal capital of the accounting acquiree. In other words, the number and type of equity instruments following the reverse acquisition must eventually reflect those of the legal parent because the consolidated financial statements are issued in its name. The requirement is to retrospectively adjust the legal subsidiary's (ie the accounting acquirer's) legal capital to reflect the capital of the legal parent (ie the accounting acquiree) [see MFRS 3.B21].

Because such consolidated financial statements represent a continuation of the financial statements of the legal subsidiary, the following principles shall be applied:

(a) The assets and liabilities of the legal subsidiary shall be recognised and measured in the consolidated financial statements at their pre-combination carrying amounts. The assets and liabilities of the legal parent shall be recognised and measured in the consolidated financial statements at their fair values at the acquisition date;

(b) The retained profits and other equity balances (such as revaluation reserves and foreign exchange reserves) recognised in the consolidated financial statements shall be the retained profits and other equity balances of the legal subsidiary immediately before the business combination. Note that the retained profits and other equity balances of the legal parent would be deemed as pre-acquisition reserves and thus eliminated on consolidation;

(c) The amount recognised as issued equity instruments (ie the contributed share capital amount) in the consolidated financial statements shall be determined by adding to the issued equity of the legal subsidiary immediately before the business combination the fair value of the legal parent (ie the deemed cost of the business combination). However, the equity structure appearing in the consolidated financial statements (ie the number of shares and the types of equity instruments issued) shall reflect the equity structure of the legal parent, including the equity instruments issued by the legal parent to effect the business combination. Accordingly, the equity structure of the legal subsidiary (the accounting acquirer) is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (the accounting acquiree) issued in the reverse acquisition [see MFRS 3.B22]; and

(d) Comparative information presented in the consolidated financial statements shall be that of the legal subsidiary because the consolidated financial statements prepared after the business combination represent a continuation of its financial statements before the business combination.

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8.2 Reverse Acquisition Accounting Procedures

It should be noted that the reverse acquisition principles are applied only in the consolidated financial statements of the legal parent. In the separate financial statements of the legal parent, the investment in the legal subsidiary shall be accounted for as an investment in accordance with the requirements of MFRS 127 *Separate Financial Statements.*

Following a reverse acquisition, the consolidated financial statements of the legal parent shall reflect the fair values of the assets, liabilities and contingent liabilities of the legal parent (ie the acquiree for accounting purposes). The deemed cost of the business combination of the legal subsidiary (ie the acquirer for accounting purposes) is therefore allocated to the fair values of the identifiable assets, liabilities and contingent liabilities of the legal parent at the acquisition date, with the difference being attributed to goodwill or bargain purchase (gain) on combination.

Example 8.1

Lembah Bhd is a small public listed company on the Stock Exchange. Maju Bhd is a private limited company controlled by the Tan family members. On 1 January 20x5, both companies are combined under the Lembah group, with the Tan family members gaining effective control over the combined entity.

The summarised statements of financial position of Lembah Bhd and Maju Bhd on 1 January 20x5 immediately before the business combination are as follows:

	Lembah Bhd	Maju Bhd
No. of ordinary shares ('000)	40,000	30,000
	RM'000	**RM'000**
Contributed share capital	120,000	240,000
Retained profits	320,000	560,000
	440,000	800,000
Long-term loans	160,000	440,000
Current liabilities	120,000	240,000
	720,000	1,480,000
Property, plant and equipment	520,000	1,200,000
Current assets	200,000	280,000
	720,000	1,480,000

On 1 January 20x5, in a ''two-for-one'' share exchange ratio, Lembah Bhd issues 60 million new ordinary shares to the Tan family members in exchange for all their 30 million ordinary shares of Maju Bhd.

The closing market price of Lembah Bhd's ordinary shares on 1 January 20x5 is RM14.00. The fair values of Lembah Bhd's identifiable assets and liabilities at 1 January 20x5 are the same as their respective carrying amounts, with the exception

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of the property, plant and equipment. The fair value of the property, plant and equipment at that date is RM600 million. An income tax rate of 25% applies to any fair value adjustment to the depreciable assets.

Required

(a) Determine the deemed cost of combination in the reverse acquisition above and goodwill on combination.

(b) Prepare the consolidated statement of financial position of Lembah Bhd immediately after the completion of the reverse acquisition.

Solution 8.1

Analysis of the reverse acquisition

As a result of the issue of 60 million ordinary shares of Lembah Bhd, the Tan family members, who are Maju Bhd's shareholders, now own 60% of the issued shares of the combined entity, the new Lembah group, ie they hold 60 million shares out of the 100 million issued shares. The remaining 40% are owned by Lembah Bhd's original shareholders. If the business combination has been structured in the form of Maju Bhd issuing additional ordinary shares to Lembah Bhd's shareholders in exchange for their ordinary shares in Lembah Bhd, Maju Bhd would have had to issue 20 million new ordinary shares for the ratio of ownership interest in the combined entity to be the same. Maju Bhd's shareholders would then own 30 million out of the 50 million shares of Maju Bhd and therefore 60% of the combined entity.

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(a) Deemed Cost of Combination and Goodwill

In applying the reverse acquisition principle, the fair value of the consideration transferred is determined by fair valuing the number of ordinary shares that Maju Bhd would have had to issue to maintain the ratio of ownership interest in the combined entity. This is more reliably measured by reference to the fair value of the equity interests of Lembah Bhd since its ordinary shares have a quoted market price.

Therefore, the consideration transferred is 20 million new shares of Maju Bhd × exchange ratio of 2 × RM14.00 per ordinary shares of Lembah Bhd = RM560 million.

The goodwill on combination is measured as follows:

	RM'000	RM'000
Cost of business combination		560,000
Fair value of Lembah Bhd's identifiable net assets:		
Book value of property, plant and equipment	520,000	
Fair value adjustment	80,000	
Fair value of property, plant and equipment	600,000	
Current assets	200,000	
Current liabilities	(120,000)	

Long-term loans	(160,000)	
Deferred tax on fair value adjustment (25% × 80,000)	(20,000)	
Fair value of net assets acquired		500,000
Goodwill on combination		60,000

As the legal parent, Lembah Bhd would have to record the issue of shares to acquire Maju Bhd in its separate financial statements, as follows:

	RM'000	RM'000
Dr Investment in subsidiary (Maju Bhd)	840,000	
Cr Contributed share capital (60m × RM14)		840,000

The number of ordinary shares of Lembah Bhd after the issuance of shares to the shareholders of Maju Bhd would increase to 100 million. The contributed share capital of Lembah Bhd after the issuance of the new shares would be RM960 million.

If Maju Bhd had issued 20 million new shares to Lembah Bhd's shareholders to maintain the ratio of ownership interest, the legal capital of Maju Bhd would have been as follows:

	Immediately before combination	Immediately after combination
No. of ordinary shares ('000)	30,000	50,000
	RM'000	RM'000
Contributed share capital	240,000	800,000

The adjustment required to reflect the type and number of shares of the legal parent would be as follows:

Number of ordinary shares ('000)	100,000
	RM'000
Contributed share capital	800,000

(b) The consolidated statement of financial position of Lembah Bhd immediately after the business combination could be derived as follows:

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	Lembah Bhd RM'000	Maju Bhd RM'000	(Dr) RM'000	Cr RM'000	Lembah Group RM'000
Contributed share capital	960,000	240,000	(840,000)a (120,000)d	560,000b	*800,000
Retained profits	320,000	560,000	(320,000)d		560,000
Revaluation reserve	–	–	(120,000)d	120,000c	–
Long-term loan	160,000	440,000			600,000
Deferred taxation	–	–		20,000c	20,000
Current liabilities	120,000	240,000			360,000
Equity & liabilities	**1,560,000**	**1,480,000**			**2,340,000**
Property, plant and equipment	(520,000)	(1,200,000)	(80,000)c		(1,800,000)
Investment in Maju	(840,000)	–		840,000a	–
Cost of combination			(560,000)b	560,000d	–
Goodwill on combination	–	–	(60,000)c		(60.000)
Current assets	(200,000)	(280,000)			(480,000)
Total assets	**(1,560,000)**	**(1,480,000)**	(2,100,000)	2,100,000	**(2,340,000)**

The consolidation adjustments are as follows:

		RM'000	RM'000
(a)	Dr Ordinary shares of Lembah Bhd	840,000	
	Cr Investment in Maju Bhd		840,000
	- to reverse the acquisition recorded by Lembah.		
(b)	Dr Cost of combination in Lembah Bhd	560,000	
	Cr Ordinary shares of Maju Bhd		560,000
	- to record deemed cost of combination.		
(c)	Dr Property, plant and equipment	80,000	
	Dr Goodwill on combination	60,000	
	Cr Deferred tax liability		20,000
	Cr Revaluation reserve		120,000
	- to adjust the net assets of acquiree to fair value.		
(d)	Dr Ordinary shares of Lembah (pre-acqn)	120,000	
	Dr Retained profits (pre-acquisition)	320,000	
	Dr Revaluation reserve (pre-acquisition)	120,000	
	Cr Cost of combination in Lembah		560,000
	- to eliminate deemed cost of combination with net assets of acquiree.		

Example 8.6

P Bhd and S Bhd are entities under common controlling shareholders. In 20x1, P Bhd acquired a 10% interest in the equity capital S Bhd for a consideration of RM200,000. The consideration was satisfied by an issue of 100,000 ordinary shares of P Bhd valued at RM2 each. The investment was treated as a simple long-term investment. P Bhd has no representation on the board of directors of S Bhd.

In January 20x6, the controlling shareholders unanimously decided to merge P Bhd and S Bhd. For the merger, P Bhd made a general offer to the holders of the remaining equity shares of S Bhd, and as result, secured an additional 80% equity interest in S Bhd. The consideration for the new shares in S Bhd was satisfied by an issue of 900,000 ordinary shares of P Bhd at an agreed price of RM2.50 each and a cash payment of RM260,000. The share capital of S Bhd has remained unchanged at 1,000,000 ordinary shares.

Required

Show the journal entries in the accounts of P Bhd to record the investment in respect of (i) the prior holdings and (ii) the new holdings as a consequence of the merger. What are the components of the cost of investment upon completion of the merger?

Solution 8.6

Journal Entries

	RM	RM
Prior Holdings		
20x1 Dr Investment in S Bhd	200,000	
Cr Contributed share capital		200,000
New Holdings		
20x6 Dr Investment in S Bhd	2,510,000	
Cr Contributed share capital		2,250,000
Cr Cash		260,000

The cost of merger with S Bhd in the accounts of P Bhd is made up as follows:

	RM'000
Full cost of prior holdings	200
Agreed price of shares issued as a consequence of the merger	2,250
Cash consideration given	260
Cost of merger	2,710

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8.7.2 The Consolidated Statement of Financial Position

In preparing the consolidated statement of financial position of the group, it is the total cost of merger which is used for the purposes of elimination to determine any difference that may arise between cost and contributed capital amount of shares acquired.

The consolidated statement of financial position should, as far as possible, simply be a line-by-line addition of the items in the statements of financial position of the parent and its merged subsidiary, without a need for adjusting the carrying amounts of assets and liabilities to their fair values. In particular, the reserves of the subsidiary as at the date of the merger, should (subject to one exception discussed below) be included in the reserves of the group.

The only items in the 2 statements of financial position that must be eliminated on consolidation are the cost of investment in the parent's statement of financial position and the parent's proportionate interest in the contributed share capital of the shares in the subsidiary's statement of financial position. On consolidation, these 2 are compared and will cancel out exactly if they are equal. However, if the 2 items are not equal, a difference will arise in the cancellation between the cost of investment and the contributed capital of shares acquired.

If the cost of merger is lower than the contributed capital of the shares acquired, a credit balance will arise in the cancellation and this difference should be treated as a capital reserve arising on merger. Note that unlike acquisition accounting, where a credit balance is treated as a gain on acquisition, the reserve arising on merger is capital in nature. Therefore, any resulting credit difference should be classified as equity and be regarded as a non-distributable reserve.

If the cost of merger exceeds the contributed capital of the shares acquired, a debit balance will arise in the cancellation and there can be practical difficulties in treating this difference. It should be noted that an important consequence of merger accounting is that goodwill on combination cannot possibly arise. Thus, the resulting debit difference cannot possibly be treated as goodwill. The difference, often called a contra reserve or merger deficit, is basically the extent to which the reserves of the subsidiary should be capitalised. In accordance with some past Standards, any resulting debit difference should be adjusted against any suitable reserve to the extent that laws or statutes did not prohibit the use of the reserve. However, in the current no par value share regime under the new *Companies Act 2016*, the only reserve that can be utilised is retained profits. In practice, some have treated the merger deficit as a ''dangling debit'' in equity without offsetting the retained profits (in this absence of a current standard on merger accounting, this dangling debit presentation is also considered an acceptable GAAP).

The table below provides a summary of the elimination process and the treatment on the difference arising:

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Profit for the year	13,635
Available for appropriation	125,625
Dividends: Interim dividends paid on 1 July 20x6	(4,355)
Final dividends paid on 31 December 20x6	(2,600)
Balance carried forward	118,670

Consolidated Statement of Financial Position
As at 31 December 20x6

	RM'000
Contributed share capital (80,000 + 45,000)	125,000
Revaluation reserves (10,000 + 90% × 40,000)	46,000
Retained profits	118,670
	289,670
Non-controlling interest 10% × (151,500 – 200)	15,130
Long-term loans	60,500
Current liabilities (13,400 + 6,550 + 500)	20,450
Total Equity and Liabilities	385,750
Property, plant and equipment	253,000
Current assets (73,400 + 59,550 – 200)	132,750
Total Assets	385,750

Workings

1. Consolidated Profit or Loss & Retained Profits

	P Bhd	S Bhd	Adjustment	P Bhd Group
	RM'000	**RM'000**	**RM'000**	**RM'000**
Revenue	50,000	55,000	(4,000)	101,000
Operating expenses	(37,005)	(41,800)	4,000	(74,805)
Unrealised profit on stock	–	(200)	–	(200)
Expenses of merger	(500)	–	–	(500)
Profit from operations	12,495	13,000	–	25,495
Finance costs	(1,800)	(1,200)	–	(3,000)
Final dividend received	1,755	–	(1,755)	–
Profit before taxation	12,450	11,800	(1,755)	22,495
Taxation	(3,900)	(4,200)	–	(8,100)
Profit after taxation	8,550	7,600	(1,755)	14,395
Non-controlling interest (10%)	–	(760)	–	(760)
Net profit for the year	8,550	6,840	(1,755)	13,635
Retained profits brought forward	60,150	51,840	–	111,990
	68,700	58,680	(1,755)	125,625
Dividends: Interim, paid	(2,600)	(1,755)	–	(4,355)
Final dividend paid	(2,600)	(1,755)	1,755	(2,600)
Retained profits carried forward	63,500	55,170	–	118,670

2. Merger Difference

	RM'000
Cost of investment in S Bhd	45,000
Share capital of S Bhd acquired 90% × 50,000	(45,000)
Difference on elimination	Nil

8.7.4 Merger Difference on Consolidation

In the above example, the shares issued are recorded at an issue price of RM1.25 (a price based on the amount of contributed share capital of the subsidiary acquired). In this case, there is no difference arising on the elimination of the cost of investment with the share of the contributed share capital acquired.

In the absence of an approved accounting standard on merger accounting, the parent may choose to record the shares issued at their fair value. If this option is availed, the cost of investment may not be equal to the share of the contributed share capital acquired. If the cost of investment is less than the share of contributed share capital acquired, a credit difference arises in the elimination. The credit difference shall be treated as a capital reserve in the consolidated statement of financial position. Conversely, if the cost of investment exceeds the share of contributed share capital acquired, a debit difference arises in the elimination. The debit difference may be written off against the retained profits of the group or held as a dangling debit in equity.

Example 8.8

A Bhd and B Bhd are 2 companies under common control. The summarised financial statements of A Bhd and B Bhd for the current year ended 31 December 20x1 are as follows:

Statements of Profit or Loss & Retained Profits
For the year end 31 December 20x1

	A Bhd	B Bhd
	RM'000	**RM'000**
Revenue	30,000	20,000
Cost of sales and operating expenses	(23,640)	(15,760)
Profit from operations	6,360	4,240

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party. The DP does *not* address the requirements on how Companies P, A and C should report the transaction because the requirements are already covered in the current IFRSs. However, no IFRS Standard specifically applies to how Company B (the receiving company) should report its combination with Company C (the transferred company) as such combinations are outside the scope of IFRS 3 *Business Combinations*.

One way to reduce diversity in practice would be to require a single method for all business combinations, including all business combinations under common control, ie applying the acquisition method set out in IFRS 3 *Business Combinations*. The acquisition method requires measuring identifiable assets acquired and liabilities assumed in the combination at fair value and requires the recognition of goodwill.

Another approach, suggested by some stakeholders and often used in practice, would be to require a book-value method for some or all business combinations under common control. The book-value method requires measuring assets and liabilities received in the combination at their existing book values, and there is no recognition of goodwill.

Some stakeholders have suggested a third method – a ''fresh start'' method (sometimes called a ''new basis'' method). That method measures at fair value all assets and liabilities of all of the combining companies, including the receiving company's own assets and liabilities. However, that method is rarely, if ever, used and received little support during the IASB's initial consultations with stakeholders. Consequently, the fresh start method is not discussed further in the Discussion Paper.

The IASB's preliminary views are that:

(e) Neither the acquisition method nor the book-value method should be applied to all business combinations under common control;

(f) In principle, the acquisition method should be applied if the business combination under common control affects non-controlling shareholders of the receiving company, subject to cost-benefit trade-off and other practical considerations; and

(g) A book-value method should be applied to all other business combinations under common control, including all combinations between wholly-owned companies.

For business combinations under common control that affect non-controlling shareholders of the receiving company, the IASB's preliminary views are that:

(a) If the receiving company's shares are traded in a public market, the receiving company should be required to apply the acquisition method; and

(b) If the receiving company's shares are privately held:

  (i) The receiving company should be permitted to use a book-value method if it has informed all of its non-controlling shareholders that it proposes to use a book-value method and they have not objected (the optional exemption from the acquisition method); and

  (ii) The receiving company should be required to use a book-value method if all of its non-controlling shareholders are related parties of the company (the related party exception to the acquisition method).

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8.9.1 Applying the Acquisition Method

If the acquisition method is applied for a business combination under common control, all the requirements set out in IFRS 3 would apply. However, business combinations under common control may contain one feature that is not present in business combinations covered by IFRS 3. Specifically, the consideration paid in business combinations under common control might be directed by the controlling party and therefore might differ from an arm's-length price that would have been negotiated between unrelated parties in a business combination covered by IFRS 3.

In a business combination under common control, the receiving company and the transferring company might not have been involved in deciding how much consideration is paid. Instead, the controlling party might have determined the amount of consideration. Any difference between that amount and the amount that would have been paid to an unrelated party in an arm's-length transaction indicates that the combination includes an additional component, ie a transaction with the owners acting in their capacity as owners. The DP rationalises that:

(a) if the consideration paid is higher, that excess constitutes a *distribution from equity* by the receiving company to the transferring company, and ultimately to the controlling party; and

(b) if the consideration paid is lower, that difference constitutes a *contribution to equity* of the receiving company from the transferring company, and ultimately from the controlling party.

> For example, assume that the fair value of the consideration paid by the receiving company is RM10,000,000. The fair value of the acquired business (ie the transferred company) is RM7,000,000 and the fair value of expected synergies is RM1,000,000. In this case, the excess is = [RM10,000,000 – (RM7,000,000 + RM1,000,000)] = RM2,000,000. This excess is akin to an overpayment, and in principle, the excess represents a distribution from equity to the transferring company, and ultimately, to controlling party.
>
> If the consideration paid is RM5,000,000, the contribution to equity is calculated at = [RM5,000,000 – (RM7,000,000 + RM1,000,000)] = RM3,000,000.

Distributions from Equity

The IASB has reached the preliminary view that it should *not* develop a requirement for the receiving company to identify, measure and recognise a distribution to the controlling party applying the acquisition method. Accordingly, in the unlikely event that an overpayment occurs in a business combination under common control that affects non-controlling shareholders, it would be initially included in goodwill and addressed through subsequent testing of goodwill for impairment, similar to a business combination with independent party covered by IFRS 3. Many stakeholders who provided their views on this matter during the development of the Discussion Paper, notably investors and analysts, agreed with that conclusion.

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Contributions to Equity

The IASB considered whether such a contribution would be likely to occur if such a combination affects non-controlling shareholders of the receiving company. The legal protections might not apply in this situation, because any such contribution would transfer wealth from the controlling party to the non-controlling shareholders of the receiving company and so would not adversely affect those shareholders. Nevertheless, the controlling party is unlikely to allow a transfer of wealth to non-controlling shareholders. Therefore, the Board has reached the view that such contributions are also unlikely to occur in practice.

However, in the unlikely event that a contribution did occur, the question arises whether it could be identified and measured and, if so, whether it should be recognised. Economically the amount of any contribution to equity equals the excess of the consideration that would have been negotiated between unrelated parties in an arm's length transaction over the consideration actually paid. In an arm's-length transaction between unrelated parties, the amount of consideration is expected to reflect the fair value of the acquired business and the price paid for any synergies expected from the combination. However, that amount would be difficult, if not impossible, to measure in practice. Hence, measuring the full amount of the contribution would not be workable in practice.

The IASB next considered whether any portion of the contribution could be identified and measured. In considering that question, the IASB analysed the requirements of IFRS 3 for bargain purchase gains. A bargain purchase gain arises if the fair value of the consideration paid is below the fair value of identifiable assets and liabilities acquired in a business combination. The Standard explains that a bargain purchase gain might happen occasionally, for example, in a forced sale in which the seller is acting under compulsion. IFRS 3 requires such a gain to be recognised in the statement of profit or loss. However, in a business combination under common control, any excess fair value of the identifiable acquired assets and liabilities over the consideration paid constitutes a contribution to equity and therefore should be reported as a change in the receiving company's equity.

Accordingly, the IASB has reached the preliminary view that it *should* develop a requirement for the receiving company in a business combination under common control to recognise any excess of the fair value of the identifiable acquired assets and liabilities over the consideration paid as a contribution to equity, rather than as a gain in the statement of profit or loss.

8.9.2 Applying the Book-Value Method

The DP introduces a new term ''book-value method'' and it is defined as ''a method in which a receiving company measures assets and liabilities received in a business combination under common control using the book values (carrying amounts) of those assets and liabilities determined by applying IFRS Standards''.

A variety of book-value methods are used in practice and various labels are used for those methods, including the predecessor method, the pooling (or uniting of interests) method or merger accounting. The DP uses the term ''book-value method'' as a collective term for all these methods.

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The IASB noted that in the absence of any specific requirements in IFRS 3 for business combinations under common control, a variety of book-value methods are used in practice. In particular, the variations relate to:

(a) measuring the assets and liabilities received – the receiving company uses either the transferred company's book values or the controlling party's book values to measure those assets and liabilities.

(b) providing pre-combination information – the receiving company includes the transferred company's assets, liabilities, income and expenses in its financial statements either:

(i) prospectively from the date of the combination, without restating pre-combination information; or

(ii) retrospectively from the beginning of the earliest period presented as if the receiving company and transferred company had always been combined, with pre-combination information restated.

> For example, in Diagram 8.1, assume that the book value of the net assets of Entity C (the transferred company) is RM50,000,000; the book value of the net assets of Entity C in the consolidated accounts of Entity A (the transferring company) and of the Entity P (the controlling party) is RM70,000,000, and the fair value of the net assets of Entity C is RM100,000,000.
>
> If Entity B (the receiving company) applies the acquisition method in IFRS 3, the net assets of Entity C would be consolidated at their fair value of RM100,000,000. However, if Entity B applies the book-value method, the contention is whether the net assets of Entity C should be included at RM50,000,000 (the book value of the transferred company) or at RM70,000,000 (the book value of the transferring entity and the controlling party).

The IASB has reached the preliminary view that, when applying a book-value method to a business combination under common control, the receiving company should measure the assets and liabilities received using the transferred company's book values rather than the controlling party's book values.

The IASB has reached the view that the benefits of measuring the consideration paid in assets at the fair value of those assets may not outweigh the costs of doing so. Therefore, the Board has reached the preliminary view that the receiving company should measure the consideration paid in assets at the receiving company's book values of those assets.

The IASB's preliminary views are that:

(a) the Board should not prescribe how the receiving company should measure the consideration paid in own shares when applying a book-value method to a business combination under common control; and

(b) when applying that method, the receiving company should measure the consideration paid as follows:

(i) consideration paid in assets – at the receiving company's book values of those assets at the combination date; and

(ii) consideration paid by incurring or assuming liabilities – at the amount determined on initial recognition of the liability at the combination date applying IFRS Standards.

8.9.3 Reporting the Difference Between Consideration Paid and Assets and Liabilities Received

The IASB noted that research for this project indicates that, in practice, when applying a book-value method, any difference between the consideration paid and the book value of the assets and liabilities received in a business combination under common control is typically recognised within the receiving company's equity.

The Board considered whether it should require that approach or a different approach. Under IFRS Standards, changes in equity arise from 1 of 2 sources – from transactions with owners in their capacity as owners (such as a contribution of equity or a distribution of dividends to shareholders) or as a result of the company's financial performance for the period. Economically, not all of the difference that may arise when applying a book-value method necessarily constitutes a contribution to, or distribution from, the receiving company's equity, nor does all of it necessarily represent income or an expense. Instead, that difference may include one or more of the following components:

(a) any difference between the consideration paid and what would have been paid to an unrelated party in an arm's length transaction.

(b) unrecognised goodwill, comprising the pre-existing goodwill in the transferred company and any synergies arising as a result of the combination. Applying a book-value method, such goodwill is not recognised because (among other reasons) the consideration paid in some business combinations under common control may not approximate the fair value of the acquired business together with the price for the expected synergies. Accordingly, recognising goodwill in those circumstances might result in measuring goodwill at an arbitrary amount that does not provide useful information.

(c) other factors such as measurement differences arising from measuring assets and liabilities received at their book values rather than at their fair values and the effects of how the consideration paid is measured under a book-value method.

The IASB has reached the view that the receiving company should not be required to segregate into components any such difference arising when applying a book-value method. The Board has also reached the view that recognising that difference in the receiving company's equity is more appropriate than recognising it as an asset, liability, income or expense.

The IASB also considered whether it should prescribe within which component of equity a receiving company should present any difference arising when applying a book-value method. The IASB noted that in practice, locations for presenting this difference include:

(a) reserves, for example, a special reserve (such as ''reorganisation reserve'') or in general reserves.

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(b) retained earnings or a similar component of equity; or

(c) share premium, additional paid-in-capital or a similar component of equity.

IFRS Standards generally do not prescribe within which component of equity particular amounts should be presented. Often, the presentation of components of equity depends on national laws, regulations or other requirements in particular jurisdictions. Accordingly, the IASB has reached the preliminary view that it should not prescribe within which component of equity the receiving company should present any difference between the consideration paid and the book value of the assets and liabilities received.

The IASB has reached the preliminary view that when applying a book-value method to a business combination under common control, the receiving company should include in its financial statements the assets, liabilities, income and expenses of the transferred company prospectively from the combination date, without restating pre-combination information.

8.10 Combined Financial Statements

In the recent years, there have been numerous discussions, both in Malaysia and in overseas jurisdictions, on the preparation and presentation of combined financial statements. In October 2014, the Malaysian Institute of Accountants (MIA) issued a practice note, ''*Guidance Note on Combined Financial Statements*'', to provide guidance on certain circumstances with respect to the preparation of combined financial statements in connection with submissions to the Securities Commission and offering documents, such as a prospectus in a public offering of securities.

The current accounting standards and company laws generally require that if a group exist (a group being defined as a parent and all its subsidiaries), the parent must present consolidated financial statements. Consolidated financial statements are prepared on the basis that all entities in the group form a single economic entity. In such circumstances, a legal group structure exists, and the consolidation financial statements are prepared to reflect the financial position and performance of that legal group. There may be circumstances where no legal group structure exists for entities operating under common control, but for which their financial statements need to be combined for specific purposes or transactions, such as a listing exercise of the combined operations within the overall group or a disposal of a carve-out business operation of the overall group.

The MIA's Guidance Note clarifies that combined financial statements are required in a circumstance where a group of entities that are under common control, but are not necessarily part of a legal sub-group. In this circumstance where there is no legal sub-group, the preparation of consolidation financial statements would not be appropriate (this would be outside the scope of MFRS 10 *Consolidated Financial Statements*). The preparation of a general purpose combined financial statements in this circumstance would be more appropriate. However, in a circumstance where separate entities that were not under common control for the reporting period but are combined for a specific purpose or transaction, this is outside the scope of the MIA's Guidance Note. In such circumstances, if the aggregation of financial information of these entities is required, preparing pro-forma financial statements may be more appropriate [MIA.GN 1.2].

8.10.1 What Are Combined Financial Statements?

Combined financial statements have been variously defined in accounting literature. One such definition is that combined financial statements are a set of financial statements that merges the assets, liabilities, net worth and operating figures of 2 or more affiliated companies. Combined financial statements are distinguished from consolidated financial statements of a company and its subsidiaries, which must reconcile investment and capital accounts. In the *IFRS for Small and Medium-Sized Entities*, combined financial statements are defined as "a single set of financial statements of 2 or more entities under common control" [IFRS.SME 9.28]. The MIA's Guidance Note defines combined financial statements as "financial statements for economic activities that are bound together by common control but are not a legal group. These are usually prepared by aggregating the financial statements of segments, separate entities or components of groups that do not meet the definition of a group under MFRS 10 *Consolidated Financial Statements*" [MIA.GN 10.2].

The 2018 Conceptual Framework defines a reporting entity as "*an entity that is required, or chooses, to prepare financial statements*". A reporting entity can be a single entity (such as a standalone reporting company) or a portion of an entity (such as a reporting cash-generating unit if it so chooses to prepare financial statements) or can comprise more than one entity (such as a reporting group). A reporting entity is not necessarily a legal entity.

If a reporting entity comprises 2 or more entities that are not all linked by a parent–subsidiary relationship, the reporting entity's financial statements are referred to as "*combined financial statements*". The requirements for combined financial statements are not yet prescribed in the MFRSs but they may be required in certain circumstances or events when 2 or more businesses or units operating under common control need to be combined for a particular purpose, such as a listing exercise of the combined businesses or units.

Determining the appropriate boundary of a reporting entity can be difficult if the reporting entity (a) is not a legal entity and (b) does not comprise only legal entities linked by a parent–subsidiary relationship. In such cases, determining the boundary of the reporting entity is driven by the information needs of the primary users of the reporting entity's financial statements. Those users need relevant information that faithfully represents what it purports to represent. Faithful representation requires that (a) the boundary of the reporting entity does not contain an arbitrary or incomplete set of economic activities; (b) including that set of economic activities within the boundary of the reporting entity results in neutral information; and (c) a description is provided of how the boundary of the reporting entity was determined and of what constitutes the reporting entity.

Example 8.9

Alpha Bhd is a parent with many subsidiaries. The Alpha group operates in many different business segments. It has 2 subsidiaries, Beta Sdn Bhd and Cama Sdn Bhd, which operate in the oil palm business; Beta Sdn Bhd is involved in the cultivation of oil palms for harvesting fresh fruit bunches (FFBs) and Cama Sdn

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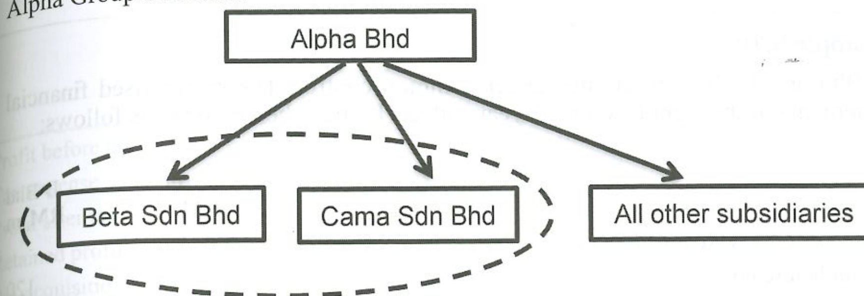
Bhd operates palm oil mills to process FFBs into crude palm oil and palm kernel. The Group has decided to combine the 2 companies in the oil palm business for a listing exercise of that business, as shown by the diagram below.

Alpha Group Structure:



8.10.2 Scenarios in Which Consolidated Financial Statements Are Required by MFRSs

In the corporate exercise above, if Beta Sdn Bhd issues its shares to acquire Cama Sdn Bhd, or vice versa (ie Cama Sdn Bhd issues its shares to acquire Beta Sdn Bhd), or indeed, a new holding company is formed and it issues shares to acquire both Beta Sdn Bhd and Cama Sdn Bhd, a group structure, as defined in MFRS 10, arises. In this case, whoever is identified as the parent entity must present consolidated financial statements in accordance with MFRS 10. As the business combination (whichever is the combination) is outside the scope of MFRS 3 *Business Combinations* because the companies are under common control, management would need to decide whether the acquisition method or the merger method would be more appropriate in the particular circumstance. The merger method may be argued as more appropriate in some types of business combinations under common control, although the detailed procedures for this method are not dealt with in the current MFRSs. The consolidated financial statements issued by the parent entity must be prepared in accordance with MFRSs.

8.10.3 When Are Combined Financial Statements More Appropriate?

In contrast, if the intention of management is to submit a 5-year track record of the combined palm oil business of Beta Sdn Bhd and Cama Sdn Bhd to a regulatory body for a listing exercise, a set of combined financial statements of the 2 companies would be a more appropriate basis to present that 5-year track record. The combined financial statements would be presented as if the 2 companies have always been combined, ie as if the businesses and activities have always been integrated as a unit. Thus, the assets, liabilities, equity (or net worth), income and expenses of both companies would be combined line-by-line as that of one unit. In preparing the combined financial statements, the principles or issues of cost of combination (eg investment in a subsidiary), elimination of investment with share capital and pre-acquisition reverses, and, in this

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(i) An economic activity being demerged from within an existing group and fused into a separate listed entity, hence the need to present historical financial information for such economic activities linked via a common element through the combined financial statements, and independently of the financial information reported within the consolidated financial statements of the entire group.

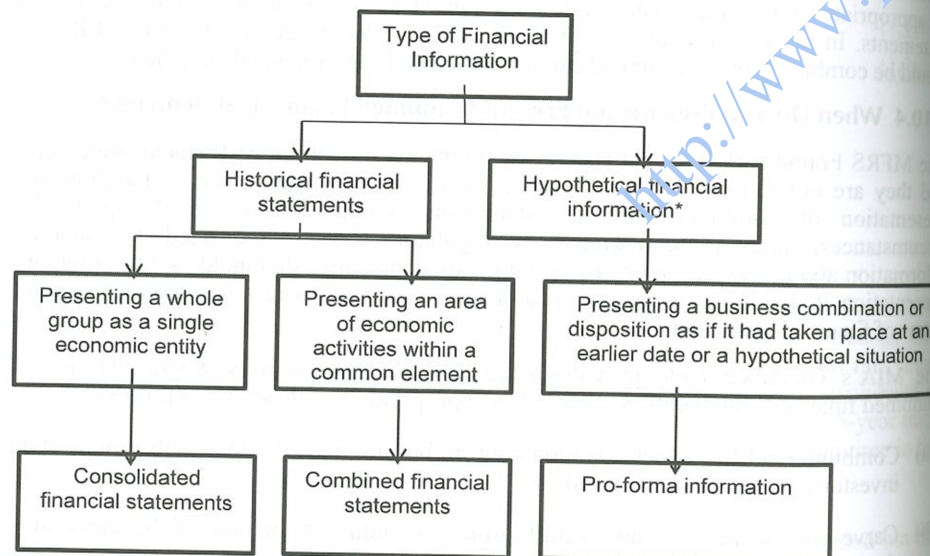
(ii) A group having demerged a significant part of its economic activities and aims to present historical financial information for its remaining economic activities to both existing as well as potential investors and shareholders via the preparation of combined financial statements, and independently of the financial information reported in the entire group's financial statements.

(c) Changes in an entity's legal form without an essential change in either its underlying business or control. This includes:

(i) Management buy-outs, whereby the business might have previously been accounted for in the financial statements of a subsidiary undertaking of the investor, but following the buy-out, the financial information instead relates to the entity formed to effect the acquisition.

(ii) A particular business having experienced a change of hands, on which the said business has been transferred from one legal entity to another, ie more-than-often a newly formed company, with no essential changes made to the underlying business.

The MIA's Guidance Note provides a chart to outline the key differences between consolidated financial statements, combined financial statements and pro-forma financial information, as reproduced below:



* *Comprised historical financial statements used to illustrate hypothetical situations.*

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The Element of Common Control

A common feature in the various definitions of combined financial statements is that the combining entities, segments, units or operations are under common control of an investor(s), which may be a parent entity or individuals that collectively controls the combining entities, segments, units or operations.

MFRS 3 *Business Combinations* clarifies that a business combination involving entities or businesses under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

A group of individuals shall be regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. Therefore, a business combination is outside the scope of MFRS 3 when the same group of individuals has, as a result of contractual arrangements, ultimate collective power to govern the financial and operating policies of each of the combining entities so as to obtain benefits from their activities, and that ultimate collective power is not transitory.

An entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of standards. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one involving entities under common control.

MFRS 3 further clarifies that the extent of *non-controlling interests* in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control. Similarly, the fact that one of the combining entities is a subsidiary that has been excluded from the consolidated financial statements of the group in accordance with MFRS 10 is not relevant to determining whether a combination involves entities under common control.

8.10.5 The Procedures in Preparing Combined Financial Statements

Generally, the procedures applied in the preparation of combined financial statements are the same as those applied in preparing consolidated financial statements. The MIA's Guidance Note explains that the procedures would typically involve the following steps:

(a) Determination of the new reporting entity;

(b) Dealing with the issues of preparation; and

(c) Disclosures of combined financial information.

8.10.5.1 Determination of the New Reporting Entity

The combined financial statements need to be issued in the name of a new reporting entity, defined in the MIA's Guidance Note as "the economic activity for which the combined financial statements is prepared". The new reporting entity is not necessarily a legal entity and it does not matter in what form the new reporting entity would take. It can be a separate vehicle formed for a particular business undertaking, such as a partnership, a business segment, a branch or other unincorporated entities, so long as that reporting entity is a separately identifiable financial structure. As defined in the MFRS

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