BULETIN

FAKULTI PERAKAUNAN

EDISI 8

An Overview of The Art of Consolidation [Statement of Financial Position]

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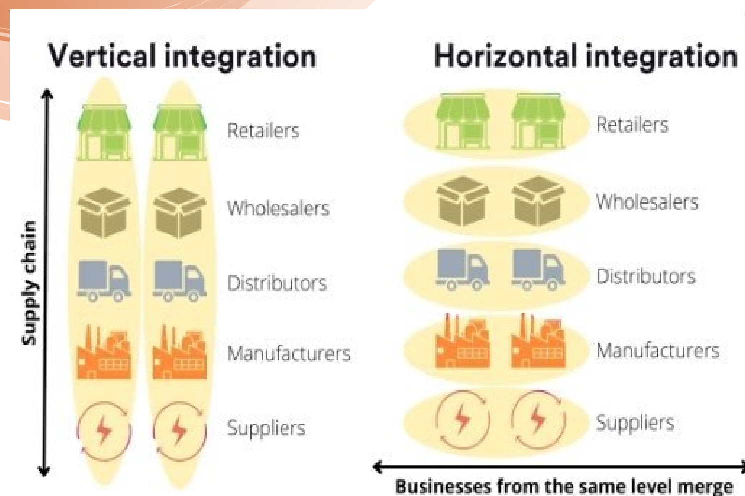
[This article only covers the basic understanding in the preparation of a consolidated statement of financial position within the scope of the course ACC507_Financial Accounting and Reporting; with references to Malaysian Financial Reporting Standard No 3 & 10. References to other MFRSs that are commonly applied in the preparation of the financial statements will not be specifically mentioned]

Business Combination

A business combination occurs when independent businesses combine to form a single unit; the combinations can be horizontal or vertical integration. Horizontal integration is an expansion strategy that involves the acquisition of a business offering similar goods or services at the same level of the value chain in the same industry.



Vertical integration is an expansion strategy where a company takes control over one or more stages in the production or distribution of its products (Lazar, 2019). Several reasons for the combination included enjoying the economies of scale, using resources more efficiently, raising additional funds, minimizing, or reducing competition, and becoming more competitive. As a result of these combinations, the financial performance, and the result of the operations of these combined entities need to be prepared through a consolidated financial statement. MFRS 3 and 10 specifically give guidelines for the financial reporting of business combinations.

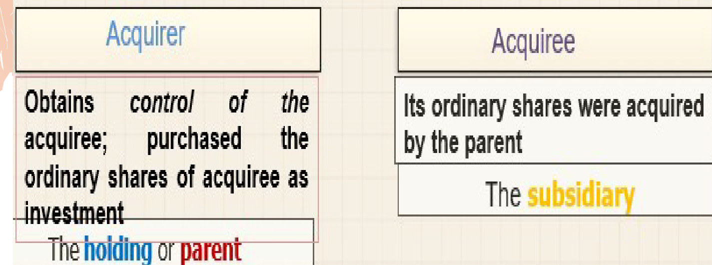
Acquirer, Acquiree, and Controlling Interest

MFRS 3 requires each business combination to apply the acquisition method by (a) identifying the acquirer, (b) determining the acquisition date, (c) recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree; and (d) recognizing and measuring goodwill or a gain from a bargain purchase. MFRS 10 states that "*A parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances"* from the date when control is acquired. The acquirer/parent company obtains control of the investee/subsidiary company if it has all the following: (a) power over the investee (b) exposure, or rights, to variable returns from its involvement with the investee; and (c) the ability to use its power over the investee to affect the amount of the investor's returns. Section 4 of the Companies Act 2016 indicates that a (parent) corporation (a) controls the composition of the board of directors of the (subsidiary) corporation; (b) controls more than half of the voting powers; and (c) holds more than half of the issued share capital of the (subsidiary) corporation, excluding the preference shares. This term is referred to as the controlling interest. The parent company with controlling interest [CI] is required to prepare a consolidated financial statement combining its own financial statements with those of its subsidiaries. Non-controlling interest [NCI] exists whenever the parent does not control 100% of the subsidiary. NCI refers to the other investors' investment in the subsidiary's voting shares.

Consolidated Statement of Financial Position [CSFP] – assuming one subsidiary company

The MFRS defines consolidated financial statements as *"The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity."* The focus of this article is only on the preparation of the CSFP.

MFRS 3: In a business combinations, one entity, the **acquirer, obtains control** of one or more other businesses, the **acquiree**



Before the CSFP can be prepared, the following need to be determined: (a) the date of acquisition, (b) the consideration transferred, and (c) the fair value of all assets and liabilities of the subsidiary. The acquisition method is applied from the acquisition date, which is the date the parent/acquirer effectively obtains control of the acquiree.

Section 4 of Companies Act 2016

A corporation shall be deemed to be a **Subsidiary** if

(a) the *other corporation* [The Parent]

(i) controls the composition of the board of directors of the corporation;

(ii) controls more than half of the voting power

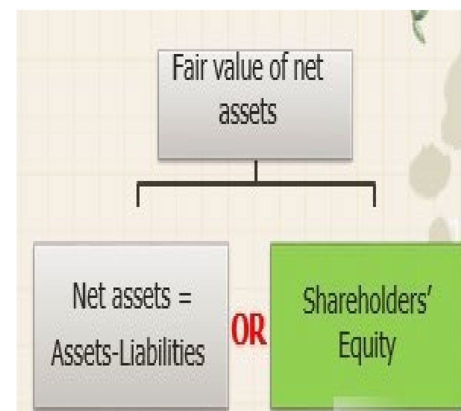
(iii) holds more than half of the issued share capital of the corporation, excluding any part of the share capital which consists of preference shares; or

(b) the corporation is a subsidiary of any corporation which is that other corporation's subsidiary.

Can exercise substantial control on the BOD decisions

Own more than 50% of the subsidiary's ordinary shares

Parent — Owns 80% of S1 — Subsidiary 1 — Owns 100% of S2 — Subsidiary 2



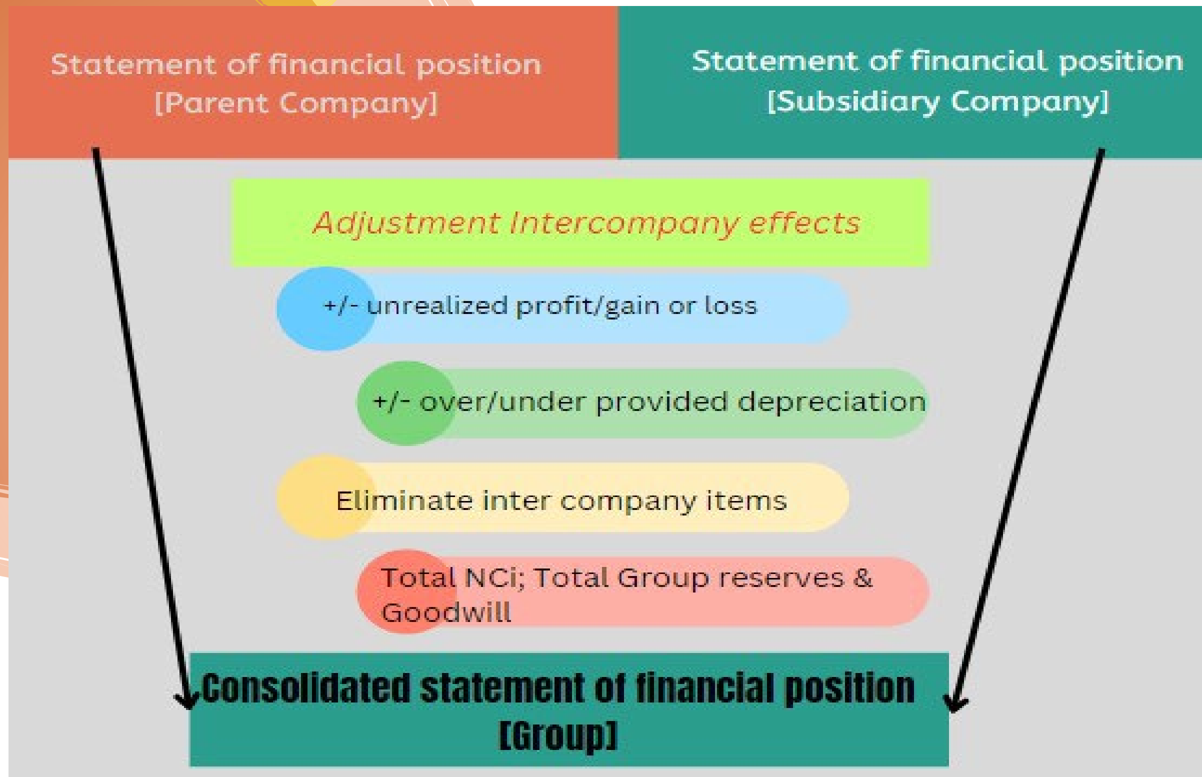
The consideration transferred refers to the cost of the parent company's investment when acquiring control of the subsidiary. On the date of acquisition, all the assets and liabilities of the subsidiary must be revalued to their fair value; thus, the parent acquired an interest in the fair value of the net assets [FVNA] of the subsidiary, and part of this FVNA will be allocated to the NCI. As part of the shareholder's equity, the reserves will be based on the pre-acquisition reserve, which represents reserves existing in the subsidiary before the parent acquired the voting shares. Basically, the following must be performed to determine the amount to be recognized in the CSFP.

Step 1: Calculate goodwill [or bargain purchase, which will be reflected in the group retained profit].

Step 2: Adjust the subsidiary's post-acquisition reserves and the parent's reserves for any effects due to intercompany/related party transactions. These are business transactions between the parent and subsidiaries, such as buying and selling goods, payments, and receipts, rendering services, and disposal of assets. All profit or loss from the intercompany transactions must be eliminated from the retained profit of the parent and subsidiary companies.

Step 3: Allocate the adjusted reserves of the subsidiary in step 2 to the group (based on CI%) and to the NCI (based on NCI%). All the reserves of the parent will be allocated in whole to the group reserves.

Step 4: Calculate the total amount for NCI, the group retained profit, and other reserves. These amounts will be transferred to the CSFP.



The total amount recognized as the group assets and group liabilities in the CSFP represents the totals after eliminating the intercompany effects. The amount for the group's issued capital only reflects the issued capital of the parent.

References

Lazar, J. (2019). *Company & Group Financial Reporting*, 9th Edition. Pearson, Malaysia. https://www.investopedia.com.

Horizontal Integration vs. Vertical Integration: An Overview.

MFRS 3 and MFRS 10. Malaysian Accounting Standards Board.