MALAYSIAN INSTITUTE
OF ACCOUNTANTS

Guidance Note on
'Combined Financial Statements'

1.0 Preamble

1.1 The Council of the Malaysian Institute of Accountants ("MIA") has approved this Guidance Note for issuance to members for adoption upon the recommendation of the Capital Markets Advisory Committee ("CMAC").

1.2 As stated in Section 130.1A of the MIA By-Laws, a Guidance Note approved and issued by the Council is considered as one of the applicable technical and professional standards to which members are expected to adhere. A breach of the MIA By-Laws will prima facie give rise to a complaint of unprofessional conduct against the member concerned. As such, members who fail to observe proper standards of ethics and professional conduct as set out in these by-laws may be required to answer a complaint before the Investigation and the Disciplinary Committees of the MIA pursuant to the Malaysian Institute of Accountants (Disciplinary) Rules 2002 [P.U.(A) 229/2002].

1.3 The Guidance Note provides 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 prospectus. Combined financial statements are required in a circumstance where a group of entities that are under common control, but that are not necessarily part of a legal sub-group. However, in a circumstance where a group of entities were not under common control for the reporting period, this is outside the scope of this Guidance Note. In such circumstances, if the aggregation of these entities is required, preparing pro-forma financial information may be more appropriate.

1.4 The Guidance Note is issued as part of the MIA's initiatives aimed at achieving the highest standards in reporting. It should be read in conjunction with the respective laws and regulations applicable to capital markets in Malaysia.

2.0 Introduction

2.1 Generally, an issuer of debt or equity securities is required by the regulators to present consolidated financial statements for financial position and results for a group of entities controlled by a parent to potential investors and shareholders. Such consolidated financial information would be prepared in accordance to *MFRS 10 Consolidated Financial Statements*. However, there may be circumstances where financial information is required for parts of a group that are under common control, but are not part of a legal sub-group, whereby the preparation of consolidated financial statements would not be appropriate. In this circumstance, the preparation of a general purpose combined financial statements would be more appropriate. Usually this relates to transactions such as business combinations, acquisitions or disposals, spin-offs or other corporate exercises involving entities under common control of an investor.

2.2 Whilst legal groups of companies can refer to *MFRS 3 Business Combinations* to account for the above-highlighted transactions, Malaysian Financial Reporting Standards ("MFRS") does not provide specific guidance on the preparation of combined financial statements. It is nevertheless, worth noting that it is accepted that combined financial statements can be prepared in accordance with MFRS in certain instances.

3.0 Applicability

3.1 This Guidance Note on 'Combined Financial Statements' is prepared specifically to address transactions for which the combining entities were under common control, but not part of a legal sub-group, of an investor for the reporting period.

4.0 What are 'Combined Financial Statements'?

4.1 Combined financial statements are prepared by combining the financial statements of separate entities, segments or components of a group that do not meet the definition of a 'legal group'.

4.2 This Guidance Note uses the term 'combined financial statements' that are prepared in accordance with MFRS. It is a general purpose combined financial statements, not a special purpose combined financial statements.

4.3 General purpose combined financial statements can only be prepared if the entities are under common control for the full or a portion of the reporting period. Furthermore, the financial results of each combined entity can only be included in the general purpose combined financial statements for the period in which that combined entity was under control by a common investor.

4.4 If the combining entities were not under common control for the reporting period, this will be outside the scope of this Guidance Note. In those circumstance, "Pro-forma Financial Information" showing the aggregated results of the various combining entities may be appropriate, setting out in detail the basis and underlying assumptions made in preparing the "Pro-forma Financial Information".

4.5 Consolidated financial statements are the financial statements of a group presented as those of a single economic entity in compliance with MFRS.

4.6 Pro-forma financial information represents hypothetical financial information formulated to illustrate how a transaction or series of transactions not limited to business combination or disposals, might have affected an entity, had this specific transaction or series of transactions been carried out at the commencement of the period being presented, or at the financial period presented in the last financial statements of the reporting entity.

4.7 Unlike consolidated financial statements which are defined by the MFRS framework, combined financial statements and pro-forma financial information are not defined. A summary analysis of the key differences in characteristics between consolidated financial statements, combined financial statements and pro-forma financial information is outlined in the chart below.

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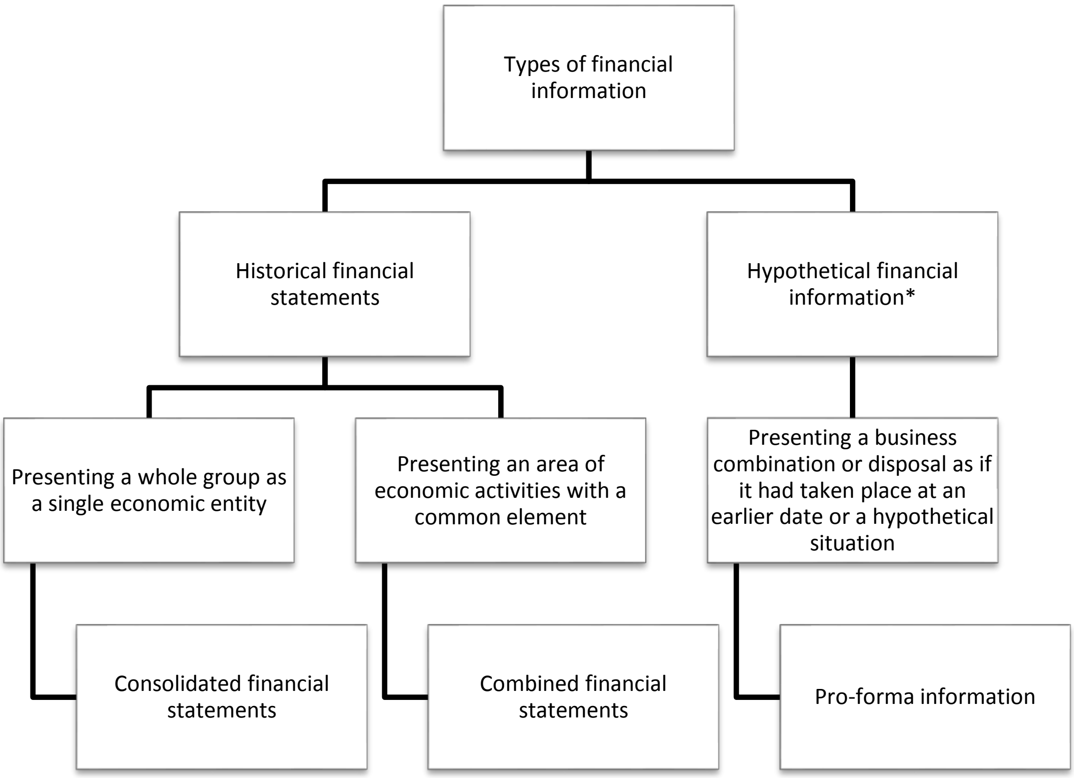

* comprised historical financial statements used to illustrate hypothetical situations

4.8 Both consolidated and combined financial statements are prepared on the basis of historical financial information. The primary difference between consolidated and combined financial statements is that the former requires the consolidation of the parent company's financial information with all its subsidiaries. In contrast, combined financial statements seek to present the historical financial information pertaining to an area of economic activities. In a nutshell, the combined financial statements are prepared in the context of a binding and common element linking the economic activities spanning the affected period.

5.0 What are the procedures in preparing 'Combined Financial Statements'?

5.1 The procedures applied to the preparation of combined financial statements are consistent with those applied when preparing consolidated financial statements in some aspects. The procedures which set out the key points to consider when preparing combined financial statements are as listed-out below:

- Determination of the new reporting entity
- Dealing with issues of preparation
- Disclosure of combined financial information

6.0 Determination of the new reporting entity

6.1 It is common for a reporting entity's group of companies in a capital market transaction to be headed by a legal entity. However, in the circumstance where the legal group structure is not in place throughout the track record period and prior to the said capital market transaction having been executed, the preparation of combined financial statements would be required. In other words, the transaction may comprise group control acquisitions or combinations of entities which may not be legally connected but are under the common control of an investor. It is therefore pertinent to establish the boundary of the new reporting entity, thus the basis for the financial reporting.

6.2 The reporting entity is an entity for which there are users who rely on the financial statements as their major source of financial information about the entity. In view of this, it is important to identify the potential users of the combined financial statements, as well as understand its purpose. For example, in an Initial Public Offering ("IPO") scenario, the users of combined financial statements would be the prospective investors who may purchase shares in an IPO and for a spin-off, the potential users are the shareholders who need to approve the said transaction.

6.3 <u>Can a business without legal boundaries be a reporting entity?</u>

6.3.1 It is not necessary for a reporting entity to be in the form of a legal entity. A reporting entity can also potentially stem from a separate vehicle not in the form of a legal entity or one that does not have a separate legal 'personality', provided that it is a separately identifiable financial structure, for example, partnership, operating segment or branch or other unincorporated entities.

6.3.2 An operating segment of a larger group, a group of entities that are legally unconnected but operating together under common control to achieve a single business objective, or entities bound together by contract could all be a reporting entity in the appropriate circumstances.

6.3.3 In a nutshell, a reporting entity represents a defined area of business activity of interest to present and potential equity investors and shareholders and financiers, amongst other relevant stakeholders.

6.4 <u>What are the factors which show that economic activities are bound together, thus forming a reporting entity?</u>

6.4.1 The two primary considerations in determining whether or not a reporting entity exists as a basis for preparing combined financial statements are listed below:

a) whether there is common control established over the assets and liabilities for the reporting period; and

b) whether the economic activity of the reporting entity is or will be legally bound together through, for example:
   - a legal reorganisation of a group or groups that is completed after the reporting date, but before release of the financial statements;
   - a reorganisation which will happen simultaneously in tandem with a proposed IPO, disposal, or such similar transaction; or
   - an agreement that was signed and taking effect during the periods covered by the combined financial statements.

6.5 <u>Must the element of common control be available for a reporting entity to exist?</u>

6.5.1 In circumstances where there is no common control, it would be difficult to identify a reporting entity, let alone establish the scope of economic activities bound by a common element in which it relates to.

6.5.2 A reporting entity where the various entities or businesses are under common control will have a unified governance process over the relevant activities, under the custody of a singular governing body. Users are then able to assess whether that governing body has made effective and efficient use of the resources on the pre-text that the entities have been under common control.

6.5.3 However, combined financial statements will only be relevant, and can only be prepared for the period in which the relevant entities were effectively under common control. Should an entity be acquired from a third party during the track record period of the combined financial statements, acquisition accounting is to be applied from the date in which control was obtained over the said entity.

6.6 Can combined financial statements still be prepared in the absence of common control over the economic activities of the proposed reporting entity?

6.6.1 It is rarely appropriate to prepare combined financial statements where the economic activities have been under common management not accompanied by common control. To further elaborate on this, common management when not supported by contractual arrangements or common control is seldom a sufficient basis to establish a reporting entity.

6.6.2 Similarly, the existence of a common business is not sufficient to establish a reporting entity. For instance, an entity may decide to acquire several businesses in the same industry over a short period of time and subsequently consolidate these businesses into a group, with the objective of achieving economies of scale and realising synergies. In this scenario, the various acquisitions of each individual business falls within the ambient of a business combination and acquisition accounting should therefore be applied rather than using combined financial statements. Although the entities acquired engage in a common business and combining financial information over the several periods might prove useful to potential investors and shareholders, however preparing combined financial statements for both the acquirer and its acquired businesses would conflict with the requirement to exclude the financial information of an acquiree prior to its acquisition given that it is not under common control.

6.7 Do the principles of consolidation accounting apply when preparing the combined financial statements of a reporting entity?

6.7.1 The combined financial statements must fully comply with the recognition, measurement and disclosure requirements respectively under the MFRS framework. In addition to this, the basic objectives of financial reporting should apply, with the objective of providing useful information for:

a) assessing management’s stewardship;
b) allowing users to assess the ability of a reporting entity to generate future cash flows; and
c) allowing comparability over time.

6.7.2 Often a reorganisation is effected to form a new reporting entity. A new entity may be formed to acquire only a portion of the existing legal group as part of the listing business. In such instance, whether the combined financial statements present a non-controlling interest requires careful deliberation on a number of factors, including whether or not the non-controlling interest survives the planned transaction. In determining the appropriate accounting treatment for non-controlling interest, due consideration must be made to ensure useful information is provided and compliance to MFRS is maintained.

7.0 Dealing with issues of preparation

7.1 What are the accounting policies to be established in preparing combined financial statements in accordance with MFRS?

7.1.1 Accounting policies should be appropriate for the purpose of preparing the combined financial statements.

7.1.2 The accounting information previously recorded in relation to the circumscribed area of economic activities represents the basis for preparing the combined financial statements. It may then be warranted to make relevant adjustments to present the combined financial statements in accordance with the reporting entity's chosen accounting policies.

7.1.3 Varying approaches are to be applied in different circumstances on a case-to-case assessment basis, for example:

a) Applying the accounting policies as per the consolidated financial statements of the group, i.e. the current parent, to which the respective economic activities belong. This approach is commonly employed where a seller is preparing financial information to be presented to existing and potential investors or shareholders, e.g. information on parts of a legal group ear-marked for disposal.

b) Employing the accounting policies to be applied in the financial statements of the new reporting entity to which the respective economic activities will belong. This is common in instances when a business is demerged from an existing group and fused into a newly-established and separate legal entity. The combined financial statements are intended to present the financial performance of the economic activities that form part of that new reporting entity.

c) The acquirer's accounting policies might be applied when the combined financial statements of the target company, i.e. acquiree, is prepared for a proposed acquisition, with the aim of presenting the financial performance of the acquiree aligned to the acquirer's accounting policies.

7.1.4 The decision with regard to the appropriate accounting policies to be established and employed will depend on the intended users of the financial information and the purpose for reporting.

7.2 <u>What income and expenses should be included in the combined financial statements of the new reporting entity?</u>

7.2.1 The combined financial statements are historical financial information and such combined financial statements of the new reporting entity should comprise of all income and expenses of economic activities arising from its business. There is a need to allocate such income and expenses to the new reporting entity for its combined financial statements to be described as prepared in accordance with MFRS.

7.2.2 Income and expenses that are clearly identifiable in all economic activities should be included in the combined financial statements, using a reasonable basis of allocation. For examples, expenses incurred at the company level might include payroll expenses, selling and administrative expenses, marketing expenses, advertising expenses, legal expenses and insurance expenses. Expenses such as other employee benefits might only be recorded at the parent level, if the employment of all human resources is handled at the parent. The allocations of such expenses should not be arbitrary but should reflect the manner in which the combining entities were managed by the common controlling investor.

7.2.3 The objective of such allocation is not to create hypothetical income and expenses as if the combining entities had always been always been a stand-alone entities. In other words, all the income and expenses recorded in the combined financial statements must be representative of the combining entities for which the combined financial statements are prepared.

7.2.4 As a principle, when performing an allocation of income and expenses and assets and liabilities, the following matters should be taken into consideration as to whether:

a) the assets and liabilities will be part of the new reporting entity;
b) there was any intra-group recharge between the parent and the new reporting entity; and
c) the recharges represent amounts actually incurred and the basis of these recharges has been established.

7.2.5 Areas that require professional judgment for allocation of income and expenses include financial costs, intercompany transactions, employee pension plans, income tax expenses and transaction costs. These are further detailed below.

7.3 Finance costs

7.3.1 Finance costs should be incorporated in the combined financial statements of the new reporting entity if, for example:

a) the debt on the parent's books specifically related to the activity of the new reporting entity, e.g. the parent has financed the new reporting entity's operations with debt, then a portion of the debt and the finance cost associated with that debt should be included in the combined financial statements of the new reporting entity; or
b) the carved out entity has historically been allocated a finance cost.

7.4 Intercompany transactions

7.4.1 The new reporting entity should re-assess the previous intercompany transactions with other entities, because these intercompany transactions may possibly become 'third party transactions' in the combined financial statements of the new reporting entity. Where entities are regarded as related parties, MFRS 124 will be applied to the related party transactions accordingly. However, the following issues may be worth considering, for example:

a) Classification of intercompany transactions may change; or
b) Liabilities of the new reporting entity may crystallise upon separation from the previous group.

7.5 Employee pension plans

7.5.1 The new reporting entity should follow the basis that is specified in the contractual agreement of an employee pension plan for allocating such expenses. If contractual agreement in respect of employee pension plan is not available, the allocation of such expenses should be based on contribution made. In other words, the allocation will equal to the contribution of the participants in the employee pension plans.

7.6 Income tax expenses

7.6.1 The new reporting entity should comply with the requirements of MFRS 112 for the preparation of the combined financial statements. The legal status of the new reporting entity subsequent to the transaction should be taken into consideration when determining allocation of such expenses.

7.6.2 The following options can be used when determining the allocation of the income tax expenses:

a) treat the economic activities as if they were an independent group for tax purposes;
b) treat the business as a separate tax payer within the group from which it is being separated; or
c) allocate tax balances on a proportionate basis by applying the overall group tax rate to the income earned by the business.

7.7 Transaction costs

7.7.1 The following issues relating to transaction costs are common in practice:
a) eligibility of IPO costs for capitalisation;
b) allocation of IPO costs among existing shareholders and shareholders who contributed new funds; and
c) whether transaction costs incurred in anticipation of an IPO can be deferred.

7.7.2 A distinction between group re-organisation costs and IPO costs should be clearly identified, as the latter represents the incremental equity issuance costs which exclude cost of staff redundancies, relocation, legal expenses and tax costs. Group re-organisation or restructuring should be expensed off as and when incurred.

7.7.3 In addition, the transaction costs must be allocated on a reasonable basis. For example, costs incurred in issuing new shares to raise capital and listing existing shares should be allocated between the new shares and the existing shares on a reasonable basis.

7.7.4 Costs incurred in issuing new shares to raise capital in an IPO exercise are regarded as transaction costs of the equity instruments and should be deducted from equity. However, costs incurred in listing existing shares on a stock exchange are not transaction costs of the equity instrument, because such costs are incurred to help the existing shares more marketable and do not relate to raising new capital. Such transaction costs should be expensed off as and when incurred.

7.7.5 Consequently, any costs incurred in listing existing shares or new shares arising from a demerger are not equity transaction costs and should be charged to the profit or loss.

7.7.6 Transaction costs paid in advance prior to issuing new equity instruments are recognised as prepayments until the transaction occurs. Subsequently the transaction costs are shown as a deduction against the new equity issued. Costs incurred must be expensed off if the transaction does not take place.

7.8 What is the extent to which subsequent events should be adjusted for?

7.8.1 The new reporting entity may receive information after the reporting period about conditions existing at the end of the reporting period relating to disclosures made in the combined financial statements, but not affecting the amounts recognised. In these circumstances, the new reporting entity should disclose the new information that relate to those conditions.

8.0 Disclosures of combined financial statements

8.1 Disclosure of relevant financial information is vital to the understanding of the reporting entity's combined financial statements in which it relates to. In addition to the MFRS requirements, disclosure requirements for combined financial statements should cover the following items, at minimum:

a) The purpose for which the combined financial statements are prepared;
b) How the new reporting entity was established and the significant judgements that were made, including the reporting parameters for the new reporting entity should be clearly explained in the basis of preparation;
c) A list of combining entities;
d) Whether the combined financial statements are prepared for general purpose, in accordance with MFRS;

e) The principal accounting policies adopted in preparing the combined financial statements;
f) The basis of allocation of assets, liabilities, income and expenses;
g) How inter-company transactions are reflected in the combined financial statements;
h) How earnings per share is calculated, if applicable; and
i) Other disclosure requirements of all applicable MFRSs.

9.0 What are examples of circumstances in which the use of 'Combined Financial Statements' is regarded as appropriate?

9.1 Examples of circumstances where the use of combined financial statements is regarded as appropriate are as pointed-out below.

9.1.1 Combining entities under common control, but not part of a legal sub-group, of an investor for the reporting period.

9.1.2 Carve-out of business of an overall group, including floatation of business in a demerger and acquisition of divisions of a group. Examples of such circumstances include the following:

a) An economic activity being demerged from within an existing group and fused into a separate listed entity, hence the need to present the 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.
b) 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 consolidated financial statements.

9.2 The requirements under applicable MFRSs shall be applied in the preparation and disclosure of relevant financial information relating to components to be included in the reporting entity's combined financial statements.

9.3 If the combining entities were not under common control for the reporting period, these will be outside the scope of this Guidance Note. In those circumstances, "Pro-forma Financial Information" for the combining entities can be prepared, setting out in detail the basis and underlying assumptions made in preparing the "Pro-forma Financial Information".

10.0 Definitions

10.1 <u>Combined financial statements</u>
Financial information 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 separate entities, segments or components of groups that do not meet the definition of a group under MFRS10.

10.3 <u>Common control</u>
Where over the economic activities lies with same ultimate party or parties bound by contract, and that control is not transitory.

Contractual arrangements can be evidenced in several ways. A contractual arrangement is often, but not always in writing, usually in the form of a contract or documented discussions between parties. Whilst it is possible for a contractual arrangement to be in non-written form, great care needs to be taken with all of the facts and circumstances to determine whether common control exists. The presumption is usually that a group of individuals does not have the collective power to govern in the absence of a contractual agreement, unless individuals within the control group are all part of the same close family group since there is unlikely to be any written contractual agreement. Control group comprising of close family group must be carefully considered based on the specific facts and circumstances. In all such situations involving family members, whenever there is evidence that the family members (irrespective of the family relationship) have acted independently then the common control exemption does not apply.

Common control is not transitory when the combining entities have been under common control for a reasonable period before and after the combination. A reorganisation within a group to facilitate a spin-off or an initial listing is a business combination involving entities under common control, although the parent loses control shortly after the transaction.

10.4 New reporting entity:
The economic activity for which combined financial statements is prepared.

11.0 Approval Date for Issuance of this Guidance Note

11.1 This Guidance Note was approved for issuance on 22 November 2018.

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