

Financial Accounting and Reporting in Malaysia

Volume 1 (6th Edition)

Financial Accounting and Reporting in Malaysia aims to develop knowledge and skills in understanding and applying the MFRSs, IFRSs and MPERS. It explains clearly the Conceptual Framework used in the preparation of financial statements for entities, including groups of companies, and how to analyse and interpret those financial statements. With a clear emphasis on local practices, accounting principles are discussed in detail to guide users on the preparation and presentation of financial statements to ensure compliance with the latest accounting pronouncements. Where applicable, comparisons are also made with the statutory requirements such as those of the Companies Act 1965, the impending Companies Act 2016 and the Securities Commission's guidelines. In addition, focus is given to providing sample comprehensive disclosures of the MFRS that may serve as guidelines for company practices. Principles and issues are summarised, explained and demonstrated with illustrative questions and answers in each accounting chapter of this issues-based book.

The sixth edition has been drafted to incorporate the new MPERS Framework, the new Companies Act 2016 and the new and amended MFRSs. These new developments in accounting standards and laws, besides being highly technical in nature, also make greater use of the fair value measurement principles. The application of the new Standards and laws requires knowledge not just in accounting per se but also proficiency in the fields of economics, finance and statistics. It has thus become increasing difficult for practitioners, preparers and students to keep pace with these new developments in the reporting standards.

Accounting practitioners, preparers and user of financial reports, as well as students will find this book indispensable.

Similarly to its previous edition, the sixth edition of Financial Accounting and Reporting in Malaysia is published in two volumes: Volume 1 is suitable for intermediate and advanced financial accounting courses while Volume 2 is suitable for advanced financial accounting courses or a post-graduate programme, although some chapters are also ideal for a course in specialised a counting or current issues.

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Other related resources include:

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- · Financial Accounting and Reporting in Malaysia, Volume 2 (5th Edition)
- · Malaysian Private Entities Reporting Standard (The MPERS Framework)
- Financial Instruments: Recognition, Measurement, Presentation & Disclosures (3rd Edition)

www.wolterskluwer.com.my

ISBN 978-967085329-1

& ACCOUNTING SERIES 2042M

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PREFACE

Public entities in Malaysia achieved full convergence with the International Financial Reporting Standards (IFRSs) of the International Accounting Standards Board (IASB) by 1 January 2012. Convergence with the IFRSs means that the due process of adopting financial reporting standards in Malaysia would have the same timeline as that of the IASB, thus putting the financial reporting in Malaysia in tandem with more than 100 countries that have adopted the IFRSs. Reporting public entities in Malaysia need to comply with both the MFRSs issued by the MASB and the IFRSs issued by the IASB. There are new and amended IFRSs and improvements made after 2012 and these have been incorporated in the MFRS Framework.

The year 2016 marked another new milestone for financial reporting of private entities in Malaysia. In February 2014, the Malaysian Accounting Standards Board (MASB) issued the Malaysian Private Entities Reporting Standard (MPERS) and this sets a new Reporting Framework, known as the MPERS Framework. Private entities were given the choice of adopting the MFRS Framework (mandatory for public entities), or by 1 January 2016, make a mandatory transition to the new MPERS Framework.

In 2015, the Companies Commission of Malaysia issued a revised Companies Bill 2015, and this Bill was enacted by the Parliament of Malaysia in April 2016. It is now known as the new Companies Act 2016, which replaces the original Companies Act 1965 in its entirety. Among others, the new Act introduces a no par value share regime and makes some amendments to the legal requirements for share buybacks, redeemable preference shares and distribution of profits. Also, the 9th Schedule of the original Companies Act 1965 has been removed, which means that the accounting requirements, treatments, presentation and disclosures will generally be in accordance with the approved accounting standards issued by the MASB.

This 6th edition of FARM 1 has been drafted to incorporate the new MPERS Framework, the new Companies Act 2016 and the new and amended MFRSs. These new developments in accounting standards and laws, besides being highly technical in nature, also make greater use of the fair value measurement principles. The application of the new Standards and laws requires knowledge not just in accounting per se but also proficiency in the fields of economics, finance and statistics. It has thus become increasing difficult for practitioners, preparers and students to keep pace with these new developments in the reporting standards.

The increase in the accounting pronouncements, both locally and internationally, has prompted a need to bridge the gap between current thinking of the standard setters and the accountancy practitioners, preparers, accountancy students and other users. A book that focuses on accounting principles (with emphasis on local practices) is necessary to guide users on the preparation and presentation of financial statements that are in compliance with the accounting pronouncements.

This book is issues-based and has been written with the accounting practitioners, preparers, students and other users in mind. It explains the principles and issues in each approved accounting standard and relates them to the actual practices in Malaysia. Where applicable, comparisons are also made with the statutory requirements, such as those of the *Companies Act 2016* and the Securities Commission's guidelines. In each accounting topic, the principles and issues are summarised,

explained, and demonstrated with illustrative questions and answers. Unlike the earlier editions of this book, we have included only limited extracts from published accounts of Malaysian companies because information about actual company practices can be easily downloaded from the Bursa Malaysia's website. Instead, we focus on providing sample disclosures of the new MFRSs that may serve as guidelines for company practices.

This book comes in two volumes and there are 23 chapters in Volume 1 and 17 chapters in Volume 2. Each chapter begins with some learning objectives to guide readers on what can be expected upon completion of the chapter. The format in the chapters is standardised for easy reference. The introduction in each chapter highlights the key accounting issues in the topic(s) concerned. This is immediately followed by detailed discussions of the requirements of accounting standards related to the topic(s) and they generally include issues of recognition, measurement, presentation and disclosures. Exposure drafts, which have been issued, are also discussed so that readers can compare these current developments with the existing standards.

Volume I is a text suitable for intermediate and advanced financial accounting courses. Chapter 1 of this Volume provides an overview of the financial accounting and reporting practices in Malaysia. Chapter 2 discusses the Conceptual Framework for Financial Reporting, a *must-read* chapter for beginners in financial reporting who wish to grasp the fundamental foundation and rationale for financial reporting. Chapter 3 focuses on the presentation of financial statements. Chapter 4 is on the preparation and presentation of single-company statement of cash flows. Chapter 5 discusses accounting policies, estimates, errors and first-time adoption of MFRSs or MPERS. Chapter 6 deals with the issues of revenue recognition. Chapters 7 to 13 relate to recognition and measurement of asset items. Chapters 14 to 20 focus on the recognition and measurement of liability items. These chapters are updated to include new topics, such as share-based payment and measurement of financial assets and financial liabilities under various models. Chapter 21 is on equity and it focuses on issuance of shares in a no par value share regime, share buybacks, redeemable preference shares, distribution of profits and solvency requirements under the new *Companies Act*. Chapter 22 discusses the framework for fair value measurement and the application of fair value measurements to assets, liabilities and equity. Chapter 23 is on reporting in hyperinflationary economies.

Volume II is a text suitable for an advanced financial accounting course or a post-graduate programme, although some chapters are also suitable for a course in specialised accounting or current issues. Chapters 1 to 4 discuss in depth the accounting for financial instruments, covering recognition, derecognition, measurement, hedge accounting, presentation and disclosures. Chapter 5 of this Volume focuses on the computation and presentation of earnings per share. Chapter 6 is on shares and business valuation, a new chapter in this 6th edition. Chapter 7 deals with business combinations. Chapters 8 to 11 focuses on issues of consolidated financial statements, accounting for investments in associates and joint ventures and the related disclosure requirements. Chapter 12 deals with the effects of changes in foreign exchange rates, including translation of financial statements of foreign operations. Chapter 13 addresses the preparation and presentation of consolidated statement of cash flows. Chapter 14 deals with disclosure issues of segmental information and related party relationships and transactions. Chapters 15 and 16 address some of the accounting issues of the specialised industries in Malaysia, such as plantation, aquaculture, agriculture, insurance, banks, unit trust funds and extractive industries. Last but not least, Chapter 17 looks at interim reporting, management commentary, voluntary and social reporting practices. and the provision of forecast information.

It is my hope that this book can assist practitioners, preparers and users of financial statements keep pace with the new accounting pronouncements. It can also be used as a reference for local accounting and reporting practices because the examples provided include some of the latest issues and trends in financial reporting. Accountancy students in universities, students sitting for professional accountancy examinations, and post-graduate students majoring in accounting and finance, should find this book particularly useful when relating accounting theories and principles to actual practices.

I hereby dedicate this book to my wife and children for without their patience and support, the drafting of this book would not have been possible.

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CHAPTER 3

PRESENTATION OF FINANCIAL STATEMENTS

This chapter will help you to:

- understand the basis for the preparation and presentation of financial statements;
- understand the concepts, principles and bases used in the preparation of financial statements; and
- apply the requirements of MFRS 101 and Sections 3–8 of MPERS in preparing general purpose financial statements.

3.1 Introduction

This chapter is on the present nion of general purpose financial statements. It deals with the application aspects of MFRS 101 *Presentation of Financial Statements* and Sections 3–8 of the MPERS Framework that deal with the same topic.

MFRS 101 and Sections 3–8 of MPERS prescribe the *basis* for the presentation of general purpose financial statements in order to ensure comparability with both the entity's own financial statements of previous periods and with the financial statements of other entities. To achieve this objective, the Standards set out the *overall considerations* for the presentation of financial statements, guidelines for their *structure* and minimum requirements for the *content* of financial statements. The Standards shall therefore be applied to the presentation of all general purpose financial statements prepared and presented in accordance with MFRSs or MPERS. Examples of general purpose financial statements are the annual financial statements prepared and presented by reporting entities to their owners. Special purpose financial statements, such as those presented to bankers for lending decisions, are not within the scope of the Standards.

3.2 Elements of Financial Statements

Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in

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making economic decisions (emphasis added). Financial statements also show the results of management stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity's:

- (a) assets;
- (b) liabilities;
- (c) equity;
- (d) income and expenses, including gains and losses;
- (e) contributions by, and distributions to, owners in their capacity as owners; and
- (f) cash flows.

MFRS 101 makes reference to the *Conceptual Framework* in prescribing information on these element in addition, both MFRS 101 and MPERS require cash flow information as its statement of changes in financiposition.

The information on these elements, along with other information in the notes to financial statement assists users in predicting the entity's future cash flows, and in particular, the timing and certainty of the generation of cash and cash equivalents.

3.3 Components of Financial Statements

A complete set of financial statements comprises the following components:

- (a) a statement of financial position as at the end of the period;
- (b) a statement of profit or loss and other comprehensive income for the period;
- (c) a statement of changes in equity for the period;
- (d) a statement of cash flows for the period;
- (e) notes, comprising a summary of significant policies and other explanatory information;
- (f) comparative information [of (a) to (e)] in respect of the *preceding period* as specified in the Standard and
- (g) a statement of financial position as at the *beginning of the preceding period* when an entity applie an accounting policy retrospectively or makes a retrospective restatement of items in its financia statements, or when it reclassifies items in its financial statements if the retrospective application restatement or reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period [MFRS 101.10].

This third statement of financial position is not a requirement in the MPERS Framework.

The previous MASB 1 used the term "balance sheet", income statement and "cash flow statement" for components (a), (b) and (d), respectively. The change in titles is to reflect more closely the function of those statements. MFRS 101 clarifies that an entity may use titles for the statements other than those used in this Standard, such as using the title "Statement of Comprehensive Income" instead of "Statement of Profit or Loss and Other Comprehensive Income".

An entity shall present with equal prominence all of the financial statements in a complete set of financial statements [MFRS 101.11].

3.4 Overall Considerations

3.4.1 Fair Presentation and Compliance with MFRSs

Require Judgements and Estimations

MFRS 101 requires that financial statements shall *present fairly* the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transaction, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework*. It is important to note that unlike past practices, which relied heavily on the prudence consideration (accountants had traditionally been viewed as prudent persons in the past), this Standard places fair presentation as its primary consideration. Selecting prudent practices may not necessarily result in a fair presentation. Thus, unlike past practices which relied primarily on the historical cost convention (being more prudent), the application of the consideration of fair presentation requires more professional judgements and estimations.

MFRS 101 clarifies that the application of MFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieved a fair presentation. In other words, it is not necessary to put the financial statements to a test of fair presentation; an entity that complies with MFRSs shall presume that its financial statements achieve fair presentation.

An Explicit Statement of Compliance

An entity whose financial statements comply with MFRSs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with MFRSs unless they comply with all the requirements of MFRSs. In practice, the fact of compliance is normally disclosed in a separate note where an explicit statement, such as "the financial statements comply with MFRSs issued by the MASB", is made. To disclose this fact of compliance, it must be a 100% compliance rate (there is no room for degrees of compliance, such as a 95% compliance rate). Financial statements that have been prepared in accordance with MFRSs shall also make an explicit an unreserved statement of compliance with IFRSs. This disclosure requirement is illustrated in the following example:

Note: Compliance with Financial Reporting Standards and the Companies Act 2016

The consolidated financial statements of the Group and the separate financial statements of the Company have been prepared in compliance with the Malaysian Financial Reporting Standards (MFRSs) issued by the Malaysian Accounting Standards Board (MASB), the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB), and the provisions of the Malaysian Companies Act 2016.

[MFRS 101.16 and .16AA]

In the past, some entities took the view that any "wrong" accounting treatment may be nullified by appropriate disclosure. MFRS 101 clarifies that inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory materials. In other words, the accounting treatments must first be "right" (ie in accordance with the standards prescribed in the MFRSs); notes and explanatory materials are additional information provided for a better understanding of the treatments. For example, if an entity defers its interest expense in a deferred asset account for the purpose of matching future revenue streams, it is not in compliance with the MFRSs; it therefore cannot rectify this "wrong" treatment with notes and explanatory materials.

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The Standard also clarifies that sometimes, compliance with the specific requirements in MFRSs mayn be sufficient to enable users to understand the impact of particular transactions, other events and condition on the entity's financial position and financial performance. In such cases, additional information shall disclosed. Thus, mere compliance with MFRSs alone may not be sufficient to meet the objective of financial statements. Voluntary disclosure of additional information may be necessary in such circumstances.

3.4.2 True and Fair View Over-ride

The issue of whether compliance with reporting standards will always result in fair presentation has bee discussed extensively by the accountancy profession and in accounting literature. The issue is concerne with whether there is any room for over-ride of accounting standards. In some jurisdictions, once accounting standards have been issued, they shall be complied with. In other words, there is no room for over-ride. Malaysia and some other jurisdictions, company laws allow for a "true and fair view over-ride" of accounting standards.

MFRS 101 acknowledges the over-ride provision in the Companies Act but makes it extremely tight for entities to avail it. It prescribes that "in the extremely rare circumstances in which management conclude that compliance with a requirement of a Standard or an Interpretation would be so misleading that it would conflict with the objective of financial statements set out in the Conceptual Framework, the entity shadepart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit such a departure". Note that in Malaysia, apart from the Financial Reporting Act and the Companies Act, the regulatory framework includes those of the other regulatory bodies, such as Securities Commission, Barl Negara Malaysia and Bursa Malaysia. These other regulatory bodies' guidelines generally do not provide for a departure of accounting standards. Thus, they may require full compliance of MFRSs by reporting entities under their jurisdictions.

It should be emphasised that the extremely rare condition shall be interpreted in the context of conflict with the *Conceptual Framework*, and not in the context of rare transactions or events that occur in a entity.

Example 1

Entity A is a parent of Pracity B and Entity C. During the current year, it undertook a group restructuring when it sold Entity C to Entity B. Arising from the sale, Entity A's group accounts recognised an unrealised profit of RM75m. This restructuring was the first time that the Group undertook such an exercise. It availed the over-ride provision of MFRS 101 by arguing that the restructuring exercise was extremely rare and hence justified the over-ride.

Required

Explain with reasons whether the over-ride meets the requirements of MFRS 101.

Solution 1

In this case, the Group has not complied with MFRS 10 Consolidated Financial Statements, which require unrealised profits arising from intra-group transactions be eliminated in full. The extremely rare condition has been wrongly applied to an event, ie the group restructuring exercise, rather than in the context of extremely rare that it conflicts with the Conceptual Framework. Also, group restructuring may not have occurred for the A Group in the past but it is not a rare event in business. Hence, the entity's over-ride of MFRS 10 is not in accordance with the requirements of MFRS 101.

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To Disclosure Departure

When an entity departs from a requirement of a Standard or an Interpretation, it shall disclose the following information:

- (a) that management has concluded that the financial statements fairly present the entity's financial position, financial performance and cash flows;
- (b) that it has complied with applicable Standards and Interpretations, except that it has departed from a particular requirement to achieve a fair presentation;
- (c) the title of the Standard or Interpretation from which the entity has departed, the nature of the departure, including the treatment that the Standard would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework, and the treatment adopted; and
- (d) for each period presented, the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement.

Also, when an entity has availed itself of a departure from accounting standards in a prior period, and that departure affects the amounts recognised in the financial statements for the current period, it shall make the disclosures set out in (c) and (d) above.

If management concludes that compliance would be so misleading but is prohibited to make a departure because of the relevant regulatory framework, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing.

- (a) the title of the Standard or Interpretation in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstance that it conflicts with the objective of financial statements set out in the Conceptual Framework; and
- (b) for each of the periods presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.

In practice, whether or not an entity shall avail the true and fair view over-ride in a particular circumstance is a matter of professional judgement.

Example 2

TIDF Bhd is preparing its group accounts for the current year ended 31 December 20x8. It has one wholly-owned subsidiary, Setia Sdn Bhd, and one 70%-owned subsidiary, Onatal Bank Bhd. The net assets (assets minus liabilities) of the three companies at year end are as follows:

	TIDF Bhd	Setia Sdn Bhd	Onatal Bank Bhd
	RM'm	RM'm	RM'm
Net assets / (liabilities)	100	80	(300)

Onatal Bank Bhd is technically insolvent. TIDF Bhd has written off, in full, its investment in the bank. It has not provided any corporate guarantee to bankers and other lenders to make good its share of losses in the bank. It is currently in the process of negotiating with Danaharta to dispose of the bank for a nil consideration.

The directors are concerned that if the accounts of Onatal Bank Bhd were consolidated, it would result in the group being placed under the PN17 class of insolvent companies on the stock exchange.

Required

Explain whether the true and fair view over-ride shall be availed in the case above.

Solution 2

In accordance with MFRS 10 Consolidated Financial Statements, the accounts of all subsidiaries shall consolidated and included in a parent's group accounts, regardless of whether the subsidiaries are solvent or not. In a case above, consolidating both subsidiaries would result in the net assets of the group being at net liabilities of RM120. The issue is whether compliance with MFRS 10, in this instance, would result in a fair presentation to shareholders a investors.

One view is that the accounts of Onatal Bank Bhd shall be consolidated (ie comply with the MFRS). Addition disclosures are then provided to explain that the negative net assets arise purely because of the requirement of MFP 10, otherwise the group net assets would still be in a positive position.

The other view is that the true and fair view over-ride shall be availed in this case because insofar as the group concerned, the worst is over. It has written off, in full, its investment in the bank and there are no further liabilitie Consolidation would otherwise result in over-statement of liabilities in the group accounts.

In practice, there have been cases of this nature where companies have availed the true and fair view over-ride. There is no clear cut answer to this case. In practice, it may be necessary to seek the consent of the regulatory bodic before an entity overrides an accounting standard to achieve fair presentation. Thus, your professional judgement required in such cases.

3.4.3 Going Concern Basis

Generally, financial statements are prepared on the assumption that the entity will continue to opera as a going concern in the indefinite future, and there is neither a necessity nor an intention to cease of curtail significantly its operations. MFRS 101 requires that when preparing financial statements, managements shall make an assessment of an entity is ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

For example, if an entity has been reporting losses in the past years and its shareholders' fund is in a defection negative net assets), its ability to continue as a going concern is doubtful. In such cases, management shat test whether or not the entity can continue to operate as a going concern in the immediate future, and this mainclude projecting and analysing future cash flows from operations, considering whether additional financial support is available, discussing with lenders and creditors, etc.

If management concludes that despite the uncertainties the entity can still operate as a going concerthe financial statements shall continue to be prepared on that basis. In such cases, the Standard requires the entity to disclose those uncertainties. For example, if the going concern basis is used due to the availability of financial support from lenders, that fact shall be disclosed.

When management concludes that the entity is no longer able to operate as a going concern, the financial statements shall be prepared on a different basis, such as liquidation or break-up basis. This fact shall be disclosed together with the reason why the entity is not regarded as a going concern.

3.4.4 Accrual Basis of Accounting

MFRS 101 prescribes that "an entity shall prepare its financial statements, except for cash flow information using the accrual basis of accounting". The accrual basis of accounting requires that items are recognised assets, liabilities, income and expenses when they satisfy the definitions and recognition criteria for those

elements in the *Conceptual Framework*. For example, revenue is recognised in profit or loss when it is earned and not when cash is received. Similarly, expenses are recognised when they are incurred and not when they are paid.

In past practice, the concept of matching was often applied to match income and expenses, resulting in some unmatched items being deferred in the statement of financial position. For example, preliminary and pre-operating expenses were commonly deferred as assets in the statement of financial position in the past, presumably to be amortised and matched with future revenue. The current MFRSs make no mention of this matching principle because it may lead to the recognition of deferred debits or deferred credits that do not satisfy the definitions of assets and liabilities set out in the *Conceptual Framework*. For example, in the case of the deferred preliminary and pre-operating expenditure in the statement of financial position, it would not meet the test of an asset because it is not a resource controlled by the entity and there are no probable future economic benefits.

Example 3

Lekas Highway Bhd operates a highway concession. Under a "Build, Operate & Transfer (BOT)" concession agreement with the Government, it is required to develop and construct roads and highways, maintain them in proper conditions and transfer the assets to the Government at the end of the concession period. In return, it is given the exclusive right to collect toll from users of the highways for a concession period of 25 years.

Lekas Highway Bhd financed the construction of the highways with substantial borrowings. After the construction of the highway was completed, it continued to capitalise interest or borrowings to an "interest equalisation account" in the statement of financial position. The interest equalisation account is being amortised over 25 years to match with the future toll revenue.

Required

Discuss whether the above "interest equalisation account" treatment is in compliance with MFRS 101.

Solution 3

The above practice of matching interest expense with future toll revenue would result in smoothening of interest expense over the 25-year concession proiod. This is not in accordance with the accrual basis of accounting becomes the deferment of the interest expense results in a deferred debit (the interest equalisation account) in the statement of financial position that does not meet the definition of an asset set out in the *Conceptual Framework*. (Note: this practice was common among concessionary companies in the past, before the MFRSs rules such practice out.)

3.4.5 Consistency of Presentation

As explained in the *Conceptual Framework*, to achieve the enhancing qualitative characteristic of comparability, the classification and presentation of items in the financial statements must be consistently adhered to. MFRS 101 requires that the classification and presentation of items in the financial statements shall be consistent from one period to the next. However, there are circumstances that may warrant or mandate a change in presentation. The Standard provides for changes in presentation when:

- (a) the entity concludes that another classification and presentation would be more appropriate (discretionary change based on management judgement); or
- (b) a Standard or an Interpretation requires a change in presentation (mandatory change).

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For example, if an entity has previously presented in the statement of financial position its capitalist plantation development expenditure, it may make a voluntary change in the current year by presenting to line item as a biological asset or plantation crop. Similarly, if an entity has previously presented its long-leasehold land as a prepayment (prepaid lease payment), it shall made a mandatory change of the previous presentation to leasehold land (as part of property, plant and equipment) following the 2010's amendment MFRS 117 Leases.

3.4.6 Materiality and Aggregation

Materiality is concerned with whether an omission or a misstatement can influence the economic decision of users of financial statements. An item is considered as material if it is capable of making a difference the economic decision made by a user. Thus, materiality should be assessed not only in relation to the size an item, but also to the nature and incidence of the item occurring. An item that is otherwise insignificant size may be a material item.

For example, consider an investor's decision to buy equity shares of an entity was based on the current year financial statements. The financial statements had omitted certain critical information on its related party transaction that were insignificant in size. Had the information been disclosed in the Snancial statements, the investor concerns would not have bought the equity shares. In this case, information on the related party relationships and transactions material because it could change the economic decision of the investor from buying the equity shares to not buying the equity shares.

MFRS 101 prescribes that "each material class of similar items shall be presented separately in the financial statements. Items of a dissimilar nature or function shall be presented separately unless they a immaterial". The number of items that can potentially be presented in the financial statements is large as the deal with many transactions and events. For example, the number of items in an entity's chart of account and trial balance could run into the hundreds. Judgement is therefore required in deciding which items she be considered as material and hence presented separately, and which items are immaterial and hence presented separately. In practice, some entities use arbitrary thresholds, such as "10% of total assets" as "5% of profit" as internal guides. These internal guides or rules are, however, not standards.

The Standard requires that when processing large numbers of transactions and other events, items a aggregated into classes according to their nature or functions. The final stage in the process of aggregation as classification is the presentation of condensed and classified data, which form the line items in the statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows or in the notes. For example, the large number of items of property, plant and equipment are aggregated and presented as one line item in the statement of financial position while the aggregate classes of property, plant and equipment are disclosed in the notes. In aggregating the items for presentation the financial statements, care shall be exercised to ensure that the items aggregated are compatible terms of their nature or function. For example, it is considered inappropriate to aggregate property, plant an equipment with intangible assets because their nature is different. Similarly, aggregating all items of current assets and presenting the aggregate as a one line item in the statement of financial position is considered inappropriate presentation, as the nature and functions of the current asset items are different.

The IASB is currently working on the concept of materiality as part of its *Disclosure Initiative*, which the umbrella term for a series of projects aimed at improving disclosures in financial statements. The IASI was informed at the Discussion Forum *Financial Reporting Disclosure* in January 2013, in its related surve and by other sources, that there are difficulties applying the concept of materiality in practice. These have resulted in a disclosure problem, namely that there is both too much irrelevant information and not enough relevant information in financial statements. A number of factors have been identified for why materiality may not be applied well in practice. One of these is that the guidance on materiality in IFRS is not clear Some think that an entity need not present a specific item in the statement of financial position, statement

profit or loss and other comprehensive income, statement of changes in equity and the statement of cash flows if the information is not material but must instead disclose it in the notes. Some are of the view that when IFRS states that a specific disclosure is required, the concept of materiality does not apply to those disclosure requirements, ie disclosures specifically identified in IFRS are required irrespective of whether they result in material information. Some also think that when a line item is presented, or a material item is otherwise recognised, in the statement of profit or loss and other comprehensive income and the statement of financial position, all the disclosures in the IFRS specified for that item must be disclosed.

The IASB observed that para 31 of IAS 1 is clear in that the concept of materiality applies to specific disclosures required by an IFRS and therefore an entity does not have to disclose information required by an IFRS if that information would not be material. Consequently, amendments have been made to IAS 1 to highlight that when an entity decides how it aggregates information in the financial statements, it should take into consideration all the relevant facts and circumstances. It emphasises that an entity should not reduce the understandability of its financial statements by providing immaterial information that obscures the material information in the financial statements or by aggregating material items that have different natures or functions. The amendments to IAS 1 aim to improve the effectiveness of disclosures that are designed to encourage entities to apply professional judgement in determining information (including where and in what order) to be disclosed in the financial statements.

3.4.7 Offsetting

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Offsetting in accounting essentially means the netting off of an asset and a liability for presentation of a net asset or a net liability. MFRS 101 prescribes that "assets and liabilities, and income and expenses, shall not be offset unless required or permitted by a Standard or an Interpretation". For example, an entity's bank fixed deposit is not offset against its bank overdraft even if they are both maintained with the same bank. Similarly, a trade receivable and a trade payable are not offset even if they relate to the same counterparty. In the statement of profit or loss, interest expense shall not be offset against interest income.

Offsetting tends to mask the significance of the particular items and hence affects the ability of users to both understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows. For example, if interest income is offset against interest expense, the net interest presented in the statement of profit or loss would give a distorted picture of the entity's gearing and its interest coverage ratio.

In certain circumstances it might be appropriate to offset items of assets and liabilities and present a net amount in the statement of financial position. For example, MFRS 132 Financial Instruments: Presentation requires that a financial asset and a financial liability shall be offset when, and only when:

- (a) there exists a legal right to offset; and
- (b) the offsetting represents the manner in which the counterparties have agreed to settle their balances on a net basis or to realise the asset and settle the liability simultaneously.

Similarly, items of income and expenses shall be offset when, and only when they relate to gains, losses and related expenses arising from the same or similar transactions and the events are not material. Such amounts should be aggregated and presented as a single line item in the statement of comprehensive income. For example, in a discontinued operation, there would be some gains and some losses arising from remeasurement of assets to their fair value less costs to sell. These gains and losses are offset and aggregated because they relate to the same event of discontinued operation.

Often, allowance accounts are maintained in the measurement of asset values. For example, allowance for doubtful debts on trade receivables and impairment allowance on property, plant and equipment. Although the asset items shall be presented net of the allowances, the net presentation is not an offsetting, as the net amount represents the expected net recoverable amount.

3.4.8 Comparative Information

MFRS 101 prescribes that "except when MFRSs permit or require otherwise, an entity shall prescomparative information in respect of the preceding period for all amounts reported in the current period financial statements. An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements".

An entity shall present, as a minimum, two statements of financial position, two statements of profit loss and other comprehensive income, two separate statements of profit or loss (if presented), two statements of cash flows, two statements of changes in equity, and two sets of related notes. If an entity presents a the statement of financial position as at the beginning of the preceding period, the related notes for that the statement must also be presented.

An entity may voluntarily present additional comparative (in addition to the minimum requirements), so as a third statement of profit or loss and other comprehensive income, so long as the information is presented accordance with MFRSs. The third statement of profit or loss and other comprehensive income can be available on its own and there is no requirement to present corresponding third statements for the other component However, notes to this third statement of profit or loss and other comprehensive income are required.

When the presentation or classification of items in the financial statements is amended, comparative amount shall be reclassified, unless it is impracticable to do so. To ensure comparability with the current period, and nature, amount of, and reason for, any reclassification shall be disclosed. For example, when an entity for applies MFRS 139, its previous classification and presentation of current and non-current investments shall amended to conform to the current year presentation required by MFRS 139, such as investments at fair value through profit or loss, available-for-sale investments and held-to-maturity investments.

When it is impracticable to reclassify comparative amounts, an entity shall disclose the reason for a reclassifying and the nature of the changes that would have been made if amounts were reclassified. To an this impracticability exemption, an entity must pass the impracticability test set out in MFRS 108 Accounting Policies, Changes in Accounting Policies, and Errors.

If narrative information provided in the financial statements for the preceding period(s) continues to be relevant in the current period, an entity discloses in the current period an updated version of that information For example, an entity discloses details (such as current status, steps taken, etc) of a legal dispute that we disclosed as uncertain at the end of the preceding period.

3.5 Structure and Content

3.5.1 Identification of Financial Statements

Financial statements shall be identified clearly and distinguished from other information in the sam published document. The other information in an annual report may include the Directors' Report, the aud report, the chairman's statement, etc.

Each component of the financial statements shall be identified clearly. In addition, the following information shall be prominently displayed and repeated when it is necessary for a proper understanding the information presented:

- (a) the name of the operating entity or other means of identification and any change in that information from the preceding statement of financial position date;
- (b) whether the financial statements cover the individual entity or a group of entities;

CHAPTER 8

CONSTRUCTION CONTRACTS, PROPERTY DEVELOPMENT ACTIVITIES & SERVICE CONCESSION ARRANGEMENTS

This chapter will help you to:

- understand the principles and practices on accounting for construction contracts and property development activities;
- · understand the requirements of accounting standards for these assets;
- · deal with the bases and accounting methods for these assets;
- deal with the disclosure requirements of the accounting standards on these assets;
- · deal with the accounting for construction of real estates; and
- deal with the accounting for service concession arrangements.

8.1 Introduction

This Chapter deals with accounting for construction contracts in MFRS 111 Construction Contracts and property development activities in FRS 201 Property Development Activities. It also discusses the requirements of IC Int 15 Agreements for the Construction of Real Estates and IC Int 12 Service Concession Arrangements. Except for IC Int 12, the Standards will be replaced by MFRS 15 Revenue from Contracts with Customers by 1 January 2018. In the MPERS Framework, Section 23 Revenue deals with construction contracts and Section 34 Specialised Activities deals with service concession arrangements and properties development activities. The requirements in MPERS are similar to the MFRSs in all material respects.

8.2 Accounting for Construction Contracts

8.2.1 Nature and Definitions

MFRS 111 Construction Contracts defines a construction contract as a "contract specifically negotiate for the construction of an asset or a combination of assets that are closely interrelated or interdependent terms of their design, technology and function, or their ultimate purpose or use".

Examples of construction contracts include contracts for the construction of highways, dams, building bridges, pipeline, ships and tunnels. The definition in the Standard also encompasses:

- (a) contracts for the rendering of services which are directly related to the construction of the asset, such services of project managers and architects; and
- (b) contracts for the destruction or restoration of assets, and the restoration of the environment follows the demolition of assets.

There are a number of ways in which contracts may be negotiated between a contractor and its customen. They may be grouped into: (a) fixed priced contracts; or (b) cost plus contracts. These are defined in the Standard, as follows:

- (a) A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses; and
- (b) A cost plus contract is a construction contract in which the contractor is reimbursed for allowable otherwise defined costs, plus a percentage of these costs or a fixed fee.

The nature of most construction contracts is that the date at which the contract activity commences at the date when the activity is completed usually falls into different accounting periods. For example, a contract for the construction of a highway or a dam rucy take up to three years. Thus, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods which construction work is performed.

Note that unlike the original IAS 11, which viewed the construction activities of a contractor to be an asset in the form of a "work-in-progress", this new Standard takes the view that a contractor provides a service to its customers, and accordingly recognises a receivable and an amount due from customer or a payable and a amount due to customer depending on the stage of completion of the contract and the progress billings made. This is because the asset under construction belongs to its customers.

8.2.2 Objective and Scope of MFRS 111

MFRS 111 prescribes the accounting treatment of revenue and costs associated with construction contract in the financial statements of contractors. It also deals with presentation and disclosure of certain line items the financial statements of contractors. This Standard shall be applied in accounting for construction contract in the financial statements of contractors.

8.2.3 Segmenting and Combining Construction Contracts

For internal control as well as for financial accounting purposes, construction contracts shall be individual identified and accounted for separately. In other words, the unit of accounting is by individual contracts. However MFRS 111 prescribes standards for when a contract for construction of a number of assets shall be segmented into separate contracts, when a group of closely related contracts shall be combined as a single contract, and when the construction of additional assets shall treated as a separate contract. These are summarised as follows

- (i) When a contract covers a number of assets, the construction of each asset shall be treated as a separate contraction contract when:
 - (a) separate proposals have been submitted for each asset;

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- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- (c) the costs and revenues of each asset can be identified. For example, a contractor may have entered into a contract with a university to construct various blocks of buildings, such as a library, a hall, an administration block and a lecture theatre. When each of these buildings has all the three criteria above, then each shall be accounted for as a separate construction contract, notwithstanding the fact that the contractor has signed one overall contract with the university.
- A group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:
 - (a) the group of contracts is negotiated as a single package;
 - (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - (c) the contracts are performed concurrently or in a continuous sequence. For example, a contractor may have entered into a contract each with 10 individual bungalow lot owners, and the owners have together negotiated with the contractor for a package deal to construct their vacant lots. If the contractor views the individual contracts to be so closely interrelated with the effect of being a single project and with an overall profit margin, and that the construction can be performed concurrently or in a continuous sequence, then all the 10 contracts shall be combined and accounted for as a single contraction contract, notwithstanding the fact that different contracts have been signed with different owners.
- (iii) A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset shall be treated as a separate construction contract when:
 - (a) the asset differs significantly in design, technology or function from the original asset or assets covered by the original contract; or
 - (b) the price of the asset is negotiated without regard to the original contract price. For example, a contractor may have entered into a contract with a customer to build an office building. Part way through the construction, the customer requested for an annexure to be built together with the bunding, and the price for construction of the annexure has been negotiated separately. In this case, the construction of the annexure shall be treated as a single contract separate from the contract to construct the office building.

The Accounting Method 8.2.4

In accounting for construction contracts, the original IAS 11 permitted a free choice of either the completed contract method, or the percentage of completion method, when the outcome of a contract can be measured reliably. Also, under the original standard, contract costs incurred were accumulated in a contract work-inprogress account (and under the percentage of completion method, the recognised progressive profits were added to the work in progress account) until the contract was completed.

MFRS 111 removes this free choice of accounting treatment by requiring that when the outcome of a construction contract can be estimated reliably, the "percentage of completion" method shall be applied. For construction contracts where the outcome cannot be estimated reliably, contract revenue shall be recognised to the extent of recoverable contract costs recognised as an expense. In this Standard, the contractor does not recognise a contract work-in-progress account because the asset under construction belongs to its customer. Accordingly, the contractor recognises a receivable or a payable in the form of gross amount due from customers or gross amount due to customers.

8.2.5 Measurement of Contract Revenue

The Standard requires that "revenue from a construction contract shall comprise:

- (a) the initial amount agreed in the contract; and
- (b) additional amounts arising from variations in contract work, claims and incentive payments;
 - (i) to the extent that it is probable that they will result in revenue; and
 - (ii) they are capable of being reliably measured".

The measurement of the initial amount agreed in a contract is usually not a problem in practice as this is either the contract value agreed in the case of a fixed price contract, or the allowable costs incurred plus a fixed fee or percentage in the case of a cost plus contract.

The amount of contract revenue may increase or decrease from one period to the next due to a variation order, or an instruction of the customer for a change in the scope of the work to be performed under the contract and this includes changes in the specifications or design of the asset and changes in the duration of the contract A variation is included in the measurement of contract revenue only when it is probable that the customer will approve the variation and the amount of the revenue arising from the variation can be reliably measured.

Additional revenue may arise from claims for reimbursement for coals not included in the contract price. These include claims for costs due to delays caused by the customer, errors in specifications or design disputed variations in contract work, and cost escalation. The inclusion of additional revenue arising from a claim is subject to uncertainties as it depends on the outcome of negotiations between the contractor and its customer. Therefore, claims are only included in the measurement of contract revenue when negotiations have reached an advanced stage such that it is probable that the customer will accept the claim, and the amount that is probable to be accepted by the customer can be measured reliably.

Additional revenue in a contract may also arise from incentive payments if specific performance standards are met or exceeded, such as early completion of a contract. Incentive payments are included in the measurement of contract revenue when the contract is sufficiently advanced that it is probable that the specific performance standards will be met or exceeded, and the amount of the incentive payment can be measured reliably.

For example, a contractor commences work on a construction contract on 1 January 20x5. The contract price is RM10,000,000 with an incentive payment of RM1,000,000 if the construction is completed on or before 31 December 20x6. When accounting for the construction contract in the early stages, the contractor shall exclude the incentive payment in the measurement of the contract revenue. When the contract is in the advanced stage and having regards to the stage of completion achieved, the contractor may conclude that it is probable the early completion will be met. Therefore, in this case, the contractor shall include the incentive payment in the revised estimate of the contract revenue.

8.2.6 Measurement of Contract Costs

The measurement of contract costs must include costs that commences from the date of securing the contract to the final completion of the contract. Costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs, if they can be separately identified and measured reliably, and it is probable that the contract will be obtained. However, in the early stages of a negotiation for a contract, costs incurred are normally recognised as an expense in the period in which they are incurred, and they are not reinstated for inclusion in the contract costs when the contract is obtained in a subsequent period.

The Standard requires that "costs of a contract shall comprise:

- (a) costs that relate directly to the specific contract;
- (b) costs that are attributable to contract activity in general and can be allocated to the contract; and

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- such other costs as are specifically chargeable to the customer under the terms of the contract".
- (a) Costs that relate directly to the contract include:
 - · costs of materials used;
 - . site labour and supervision;
 - · costs of sub-contractors;
 - . depreciation of plant and equipment used;
 - · costs of transporting materials, plant and equipment;
 - · costs of hiring plant and equipment;
 - costs of design and technical assistance that is directly related;
 - · costs of rectification and guarantee work, including warranty costs; and
 - · claims from third parties.
- (b) Costs that are attributable to the contract activity in general and there exists a reasonable basis for the costs to be allocated to the contract. These include:
 - insurance on construction contracts;
 - costs of design and technical assistance that are not directly related to a specific contract;
 - other construction overheads; and
 - borrowing costs, when the contractor uses borrowings to finance the construction (see MFRS 123 Borrowing Costs). However, for private entities, MPERS does not permit capitalisation of borrowing costs.
- (c) Such other costs are specifically chargeable to the customer under the terms of the contract. These may include some general administration and development costs for which the reimbursement is specified in the terms of the contract.

8.2.7 Recognition of Contract Revenue and Expenses

The Standard makes use of the *Conceptual Framework* to determine when contract revenue and contract costs shall be recognised as revenue and expenses in profit or loss. More specifically, the Standard requires that:

- (i) When the outcome of a contact can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses by reference to the stage of completion of the contract activity at the end of the reporting period [MFRS 111.22]; and
- (ii) When the outcome of a contract cannot be estimated reliably, contract revenue shall be recognised only to the extent of contract costs incurred that are recoverable, and contract costs shall be recognised as an expense in the period in which they are incurred. [MFRS 111.32]

The stage of completion shall be measured by the method that reflects the work performed, which may be an "input" measure or an "output" measure. The Standard does not prescribed a preference for any particular method but mentions that the methods may include:

- (a) contract costs incurred to date as a proportion of the estimated total contract costs (an input measure);
- (b) surveys of work performed, for example, the value of work certified as a proportion of the total contract revenue (an output measure); or
- (c) completion of a physical proportion of the contract work (an output measure).

As the measurement of stage of completion is an estimate of the work performed, a contractor may choose to apply different measurement methods to different types of construction contracts. However, for consistency, contracts of the same type or nature shall be measured using the same method. For example, a contractor may

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apply the costs incurred method to measure stage of completion for all its housing development contracts, he may apply the survey method to measure the stage of completion for all its engineering contracts.

Progress payments and advances received from customers generally do not reflect work performed and accordingly, shall not be used as a measure of the stage of completion. For example, some construction contracts may require the customers to pay upfront a 10% of the contract value at the commencement of the contract. On the other hand, some other turnkey-type of construction contracts may have no payments until the entire contract is completed. Thus, payments received, whether upfront or at the end of the contract, been or resemblance to the work performed to date in any reporting period.

Example 1

As at 31 December 20x8, Gangsa Contractor has accumulated, in one of its contract accounts, an amount of RM12,000,000. Included in this account are RM400,000 of materials set aside for future work and RM500,000 payment in advance to subcontractors. Further costs to complete the contract are estimated at RM16,000,000.

Total contract revenue is RM35,000,000. As at 31 December 20x8, the value of work certified by an independent architect is RM15,000,000.

Stage of completion measured by reference to contract costs incurred to dz'e's = [12,000,000 - 400,000 - 500,000] [11,100,000 + 16,000,000] = 41%.

Stage of completion measured by value of work certified is: [15,000,000]/[35,000,000] = 43%.

8.2.7.1 Accounting Entries for the Percentage of Completion Method

The following journals summarise the accounting requirements under this method:

As and when costs are assigned to a contract.

Dr Contract costs

Cr Cash/Payroll/Accurrenated depreciation

At the end of each reporting period, contract costs that relate to future activity are carried forward as an asset (inventories) as follows:

Dr Construction materials, supplies, etc Cr Contract costs

The net contract costs represents the amount incurred and is closed off to the statement of profit or loss for the period. Note that if an entity applies MFRS 15, the costs incurred are initially capitalised in a contract asset account (for example, as a contract-in-progress) and at the end of each reporting, an appropriate amount is amortised as cost of sales in profit or loss by reference to the amount of revenue recognised in profit or loss, ie applying the percentage of completion method.

As and when customers are billed:

Dr Accounts receivable
Cr Progress billings account

When cash is received from customers:

Dr Cash account

Cr Accounts receivable

At the end of each period, contract revenue is recognised based on the stage of completion as follows:

Dr Progress billings account

Cr Contract revenue in profit or loss

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A contractor commences work on a fixed price contract of RM170,000. At year end, it has accumulated contract costs of RM50,000 of which RM6,000 represents unused materials at the construction site. Further costs to complete the contract are estimated at RM66,000. Progress billings amount to RM60,000. A 10% retention money is retained and the customer pays the balance by the end of the year. Stage of completion is measured by reference to costs incurred to date as a per cent of estimated total contract costs.

Required

Show the summarised journal entries to record the above construction contract.

The summarised journal entries would be as follows:

	RM	RM
Dr Contract costs	50,000	
Cr Cash/Payroll/Accumulated depreciation		50,000
- to record costs assigned to contract.		
Dr Construction materials	6,000	
Cr Contract costs		6,000
- to carry forward as an asset, unused materials at year end.		
Dr Accounts receivable	60,000	
Cr Progress billings account		60,000
– to record billings to customer,		
Dr Cash account	54,000	
Cr Accounts revervable		54,000
– to record cash received from customer.		
Dr Progress billings account	68,000	
Cr Contract revenue (40% × 170,000)		68,000
– to recognise revenue based on 40% completion.		
The extract of the profit or loss would be:		
	RM RM	
Contract revenue	68,000	
Contract costs (50,000 - 6,000)	(44,000)	
Recognised profit	24,000	

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The extract of the statement of financial position would be:		
Inventories — unused materials	RM	
Accounts receivable (60,000 – 54,000)	6,000	
	6,000	
Gross amount due from customers — unbilled amount being revenue in excess of progress billings	8,000	
Note to the accounts would be as follows:	20,000	
	RM	
Costs incurred to date	44,000	
Add: Recognised profits	24,000	
Less: Progress billings		
Gross amount due from customers	(60,000) 8,000	

8.2.8 **Estimate of Outcome of Contract**

Contract revenue and costs are recognised in profit or loss by reference to the stage of completion only when the outcome of a contract can be estimated reliably. MFRS 111 prescribes that for a fixed price contract a reliable estimate of outcome requires all of the following conditions to be met:

- (a) total contract revenue can be measured reliable:
- (b) it is probable that the economic benefits associated with the contract will flow to the entity;
- (c) both the contract costs to complete the contract and the stage of contract completion at the balance sheet date can be measured reliably; and
- (d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

- (a) it is probable that the economic benefits associated with the contract will flow to the entity; and
- (b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

When the contract outcome cannot be estimated reliably, contract revenue is recognised only to the extent of costs that are recoverable, while contract costs incurred in the period are recognised as an expense.

Example 3			
A contractor has two contracts, W and Y contract W were RM10,000 and the amour which RM2,000 is not recoverable.	7, for which their outcome cannot is fully recoverable. Costs in	ot be estimated reliably. Cocurred for contract Y were	ests incurred for e RM15,000 of
	Contract W RM	Contract Y RM	Total RM
Revenue recognised Costs incurred in the period	10,000 (10,000)	13,000	23,000

(10,000)

Profit or (loss)

(15,000)

(2,000)

(25,000)

(2.000)

Change in Estimate of Outcome

There may be uncertainties that prevented the outcome of a construction contract being estimated reliably. These may include uncertainties in cost estimates in respect of work for which the contractor has no prior experience, recovery of contract costs may not be probable or in the early stages of longer-term construction contracts. Therefore, it is appropriate that in such circumstances, no profit shall be recognised. An entity may adopt, as a matter of internal accounting policies, that outcome of construction contracts would be deemed as uncertain when the stage of completion is below a certain percentage, such as 10%. Thus, with such an internal policy, no profit is recognised for any contract that is below the 10% stage of completion.

However, when the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract shall be recognised based on the stage of completion method. In other words, once the uncertainties are resolved, the entity reverts back to its normal percentage of completion method.

Example 4

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Gumuda Bhd undertakes a construction contract with a fixed price of RM100,000. In the prior year ended 31 December 20x4, there were significant uncertainties that prevented the outcome of the contract being estimated reliably. Accordingly, contract revenue and contract costs recognised in the income statement in the prior year were RM20,000 each

For the current financial year 20x5, the uncertainties are resolved. Additional contract costs incurred in the current year amount to RM25,000. Further costs to complete the contract are estimated at RM35,000. Progress billings at 31 December 20x5 amount to RM40,000. The company uses the costs incurred basis to measure the stage of completion.

Required

Compute the revenue and cost that should be recognised in the current year. Also show the amount due from customer.

Solution 4

Stage of completion = RM45,000/(RM45,000) + RM35,000) = 56.25%

	RM
Revenue to date (56.25% × RM100,000)	56,250
Less: Revenue recognised in the prior year	(20,000)
Revenue for the current year	36,250
Costs to date (56.25% × RM80,000)	45,000
Less: Costs recognised in the prior year	(20,000)
Costs as an expense for the current year	25,000
Gross profit in the income statement	11,250
r .	

Gross amount due from customers:

	RM
Costs incurred to date	45,000
Add: Recognised profit	11,250
Less: Progress billings	(40,000)
Gross amount due from customers	16,250

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8.2.9 Recognition of Expected Losses

Regardless of whether or not the outcome of a contract can be estimated reliably, the Standard require that an expected loss on a construction contract shall be recognised as an expense immediately. In other words, the full expected loss is recognised immediately regardless of the stage of completion of the contract

This Standard effectively requires that the entity applies an impairment test on its construction contract whenever there is any indication of impairment, judged by an estimate of the expected loss.

Example 5

A contractor has a fixed price contract with a value of RM10,000,000. As at 31 December 20x8, contract costs incurred to date amount to RM5,000,000. Estimate of further costs to complete the contract is RM8,000,000. Stage of completion is measured by reference to costs incurred to date.

Required

Compute the loss that should be recognised in the current year.

Solution 5

The stage of completion is 38.5% [ie RM5,000,000/(RM5,000,000 + kM8,000,000)]. Revenue, cost and los recognition would be as follows:

	RM'000
Contract revenue (38.5% × RM10,000,000)	3,850
Contract costs (38.5% × RM13,000,000)	(5,000)
Loss incurred on contract to date	(1,150)
Estimated future loss on contract recognised as an expense (1 – 0.385) × RM3,000,000	(1,850)
Total loss on contract recognised	(3,000)

8.2.10 Construction Contracts with Non-Monetary Considerations — Barter Trade

In revenue accounting, the general principle is that revenue should be measured at the fair value of the consideration received or receivable. In a construction contract where the revenue receivable is in cash, the measurement of revenue is straightforward.

In some construction contracts, the contractors do not received monetary considerations but are instead compensated by non-monetary assets, ie a barter trade transaction of contract work for non-monetary assets. Common examples of this type of contract arrangements include:

- (a) a contractor undertaking construction work for a property developer and in return is compensated in building units;
- (b) a developer undertaking the construction of a property for a government and in return is compensated by a piece of land from the government; and
- (c) an entity bearing all the costs of construction of an office building for a land owner and is given the right to use the building for a specified time period free of rental.

In all such cases, the entity undertaking the construction would need to measure revenue by reference to the fair value of the non-monetary assets. When the compensation is in building units receivable, the fair value may be measured by reference to the selling prices of those units. In the case of compensation in land from the

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government, the revenue receivable is the measured at the market price of the land less any cash consideration paid to the government. When the compensation is in the form of right-of-use asset (an intangible asset) and its fair value cannot be measured reliably, revenue may be determined using a cost-plus margin approach.

A Case on Barter Trade

Buildcon Sdn Bhd is in the construction business. In the prior year ended 31 December 20x5, the directors had decided that the company shall venture into the hotel business. On 1 January 20x6, the company negotiated with the Selangor State Government to acquire a piece of land in Cyberjaya for the purpose of building a five-star hotel in the area.

The terms of the agreement with the State Government were as follows:

- Buildcon Sdn Bhd shall construct a cultural complex in another piece of land in Cyberjaya and bear all the costs of construction of the complex. Upon completion of the construction, the complex shall be transferred to the State Government; and
- The State Government shall alienate the stated piece of land to Buildcon Sdn Bhd for a price of RM3,500,000.

On 31 January 20x6, the land was alienated to the company upon payment of RM3,500,000. The fair value of this land on this date was estimated by an independent professional valuer at RM25,000,000.

In February 20x6, Buildcon Sdn Bhd commenced work on the construction of the cultural complex. The estimated total construction costs of the cultural complex were RM16,500,000. As at 31 December 20x6, construction costs incurred on the complex amounted to RM9,900,000.

Also, the company commenced work on the construction of the hote in March 20x6. As at 31 December 20x6, construction costs for the hotel totalled RM10,000,000.

Required

Discuss the recognition and measurement requirements in the case above, showing clearly the elements that shall be recognised in the financial statements of Buildcon Sdn Aid for the year ended 31 December 20x6.

Solution to Case

Buildcon Sdn Bhd shall recognise the work on the cultural complex as a separate construction contract in accordance with MFRS 111. To measure the contract revenue, the company shall record the land acquired at its fair value of RM25,000,000. The difference between the tair value of the land received and the cash consideration paid shall represent the fair value of contract revenue received in advance, as follows:

	KIVI
Fair value of land received	25,000,000
Less: Cash paid	(3,500,000)
Difference as contract revenue for the complex	21,500,000
Less: Estimated total contract costs	(16,500,000)
Estimated profit on the complex project	5,000,000
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Therefore, to recognise the land acquired, the journal entries would be as follows:

	RM	KIVI
Dr Land, as property, plant and equipment	25,000,000	
Cr Cash account		3,500,000
Cr Deferred contract revenue		21,500,000

Financial Accounting and Reporting in Malaysia, Volume 1

CHAPTER 15

LEASES

This chapter will help you to:

- understand the various types of lease arrangements;
- understand the accounting principles for finance leases and operating leases in the books of lessees and of lessors;
- · deal with the recognition, measurement and presentation of leases;
- · deal with sale and leaseback arrangements; and
- understand the requirements in the new MFRS 15 Leases.

15.1 Introduction

15.1.1 What is a Lease?

Leasing is basically a process whereby the owner of a particular asset (the lessor) enters into an agreement (the lease) with the user (the lessee) for the latter to use the asset for a specified period of time. The lessee pays a certain amount (lease payment) periodically to the lessor for the use of the asset, but the legal title to the asset continues to be vested with the lessor. In Malaysia, the use of lease as a source of finance began in the early 1970s and today, it is one of the most important methods of financing property, plant and equipment, particularly in financing new machinery, equipment and vehicles.

Accounting for leases in Malaysia is currently governed by MFRS 117 *Leases*, which defines a lease as "an agreement whereby the lessor conveys to the lessee in return for a payment, or series of payments, the right to use an asset for an agreed period of time". This definition also includes hire purchase contracts for an asset. For private entities, Section 20 *Leases* of MPERS has requirements on lease accounting that are similar in all material respects with MFRS 117.

15.1.2 Scope of MFRS 117

MFRS 117 deals with lease accounting in the books of the lessee and the lessors. It also provides guidance on accounting for finance lease by dealers and manufacturers, and on sales and leaseback transactions. However, the scope of MFRS 117 does not cover the following types of leases:

- (a) leases to explore for or use minerals, oil, natural gas and other similar non-regenerative natural resources; and
- (b) licensing agreements for such items as motion pictures films, video recordings, plays, manuscripts, patents and copyrights.

Also, this MFRS shall not be applied as a basis for measurement for:

- (a) property held by lessees that is accounted for as an investment property (MFRS 40 *Investment Property*)
- (b) investment property provided by lessors under operating leases (see MFRS 140);
- (c) biological assets held by lessees under finance leases (see MFRS 141 Agriculture); and
- (d) biological assets provided by lessors under operating leases (see MFRS 141).

However, leases of lands and buildings are within the scope of this Standard.

15.2 Classification of Leases

Applying Substance over Form

MFRS 117 classifies leases into two broad categories: finance leases and operating leases. The main criterion used in the classification is the extent to which risks and rewards incidental to ownership of the leased asset lie with the lessor or with the lessee (ie it uses a "risks and rewards" approach).

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of the asset from the lessor to the lessee. Title may or may not eventually be transferred. By default, all other leases which do meet this criterion are to be classified as operating leases.

It is evident that MFRS 117 relies on the consideration of substance over form in deciding whether a lease shall be classified as a finance lease or an operating lease. For example, in form, a lessee may not eventually obtain the legal title to the leased asset, but if the financial and economic reality of the transaction is such that the lessee obtains all the benefits (and the accompanying risks) from the use of the asset, then in substance, the transaction is a finance lease. Finance leases are normally non-cancellable such that the lessee assumes most of the risks of the assets, such as technological obsolescence, damages, etc. Also, the lessor, in financing the purchase of the leased asset normally expects to recover his capital outlay plus a return on his investment by letting out the leased asset principally to a single lessee.

MFRS 117 provides five examples of situations that individually, or in combination, would normally lead to a lease being classified as a finance lease, as follows:

- (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- (e) the leased assets are of a specialised nature that only the lessee can use them without major modifications.

The above indicators of situations shall be used to operationalise the meaning of "transfer substantially all risks and rewards incidental to ownership" in the classification of a finance lease. It shall be emphasised that as long as any one of the situations is satisfied, the lease shall be classified as a finance lease. Thus, the transfer of title (ie its legal form) is of secondary importance as the title may or may not eventually be transferred.

A hire purchase contract for the hire of an asset would also fall within the definition of a finance lease. Hire purchase contracts in Malaysia contain provisions which transfer the title of the asset to the hirer upon payments of all the hire purchase instalments. Although the income tax law may require separate treatments

Chapter 15: Leases

for finance lease and hire purchase assets for the purpose of capital allowances, they shall be treated as finance leases for accounting purpose in accordance with MFRS 117.

The five examples provided in the Standard are not an exhaustive list of situations for classifying a finance lease. Otherwise, entities may be able to circumvent the requirements of the Standard by entering into leasing arrangements that do not meet any of the five examples, and thereby enjoy the benefits of off-balance sheet financing, which would make the entities appear less geared compared to their economic reality. MFRS 117 explains that there are other indicators of situations which individually, or in combination, could also lead to a lease being classified as a finance lease; as follows:

- (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- (b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- (c) the lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

In practice, some arbitrary thresholds or "bright-line" rules have been applied to operationalise the transfer of risks and rewards. For the major part of the economic life criterion, a 75% rule is normally applied. For example, if the economic life of a leased asset is 10 years, a lease period of 7.5 years or more would meet the transfer of risks and rewards test. For the present value test, a 96% rule is normally applied. For example, if the present value of the minimum lease payments is 90% or more of the fair value of the leased asset, the lease is classified as a finance lease. It shall be emphasised that unlike the original MASB 10 *Leases*, MFRS 117 does not provide for such thresholds or bright-line rules. What shall be considered as major part of the economic life of a leased asset or what amounts to substantially all of the fair value of the leased assets are matters of judgement for the reporting entities.

All other leases that cannot be classified as a finance lease shall be treated as operating leases. *Operating leases* are those where substantially all the risks and rewards incidental to ownership are not transferred. These are normally service leases, where the lessor seeks to recover his capital outlay plus a return on his investment by letting out the asset to a few lessees. They are normally cancellable at the option of the lessee. From the viewpoint of the lessee, an operating lease of equipment is more like a rental of equipment, such as a rental of photocopying machine.

Example of an Accounting Policy Disclosure on Leases

4.17 Finance and Operating Leases

The Group recognises a lease whenever there is an agreement, whether explicitly stated as a lease or otherwise, whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. Title may or may not eventually be transferred. All other leases that do not meet this criterion are classified as operating leases.

[MFRS 117.8 and 1C 4]

(a) Lessee Accounting

If an entity in the Group is a lessee, it capitalises the underlying asset and the related lease liability in a finance lease. The amount recognised at the commencement date is the fair value of the underlying leased asset or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate is used. Any initial direct costs of the lessee are added to the amount recognised as an asset.

[MFRS 117.20]

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Minimum lease payments are apportioned between the finance charge and the reduction of the outstanding liability The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of interest. on the remaining balance of the liability. Contingent rents are charged as expenses in the periods in which they are

Capitalised leased assets are classified by nature and accounted for in accordance with applicable MFRSs. If the is no reasonable certainty that the lessee will obtain ownership by the end the lease term, the asset is depreciated on the shorter of the lease term and its useful life.

For operating leases, a lessee in the Group does not capitalise the underlying leased asset or recognise a lease liability. Instead lease payments under an operating lease are recognised as an expense on the straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's [MFRS 117.33]

(b) Lessor Accounting

If an entity in the Group is a lessor in a finance lease, it derecognises the underlying asset and recognises a lease receivable measured at an amount equal to the net investment in the lease. [MFRS 117.36]

Finance income is recognised in profit or loss based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease. [MFRS 117.39]

For a lessor in the Group, the underlying asset in an operating lease is not derecognised but is presented in the statement of financial position according to the nature of the asset. [MFRS 117.49]

Lease income from operating leases is recognised in profit or tors on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished. [MFRS 117.50]

15.3 Lessee Accounting

15.3.1 Accounting for Finance Leases by Lessees

In the case of a finance lease, although the lessee may obtain no legal title to the asset, the substance over form consideration requires that the lessee capitalises the leased asset and recognises the related finance lease obligation. Thus, the lessee shall record an asset (representing the rights) and the liability (representing the lease obligations).

15.3.1.1 Measurement of leased asset and depreciation

The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:

- (a) a lease is classified as either an operating or a finance lease; and
- (b) in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

The inception date may be different from the commencement of the lease term, which is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (ie the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate).

The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

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er ut he Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

- for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
- (h) for a lessor, any residual value guaranteed to the lessor by:
 - (i) the lessee;
 - (ii) a party related to the lessee; or
 - (iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

At the commencement of the lease term, a lessee shall recognise a finance lease as an asset and a corresponding liability in its statement of financial position at an amount that is equal to the fair value of the leased asset or, if lower, at the present value of the minimum lease payments, each determined at the inception of the lease. In calculating the present value of the minimum lease payments, the discount factor is the interest rate implicit in the lease, if this rate is practicable to determine; if not, the rate shall be the lessee's incremental borrowing cost. Any initial direct costs of the lease are added to the amount recognised as an asset.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of: (a) the minimum lease payments; and (b) the unguaranteed residual value to be equal to the sum of: (i) the fair value of the leased asset; and (ii) any initial direct costs of the lessor.

For example, assume an asset in a lease has a fair value of RM70,000. The lease term is five years, the lease payments are RM10,000 per year, the unguaranteed residual value accruing to the lessor is RM40,000 and the initial direct costs of the lessor are RM1,000. The interest rate involving in the lease is calculated as follows:

RM70,000 + RM1,000 =
$$\sum_{i=1}^{5} \frac{19,000}{(1+r)^i} + \frac{40,000}{(1+r)^5}$$

Where r, the interest rate implicit in the lease, is 6.40%.

As the interest rate implicit in the lease is defined in such a way that it includes the unguaranteed residual value and initial direct costs of the lessor, it is effectively the rate that the lessor charges the lessee in the lease arrangement. If that rate cannot be readily determined (for example, when the lessee is not able to determine the unguaranteed residual value accruing to the lessor) the lessee shall use its *incremental borrowing rate*.

Example 1

On 1 January 20x1, Manja Bhd enters into a finance lease agreement with Alpha Leasing Bhd for the use of a machine. The agreement calls for five yearly instalments of RM25,000 each, with the first payment due on 31 December 20x1. The machine could be bought outright for cash of RM100,000. The interest rate implicit in the lease is not readily determinable. Manja Bhd's incremental borrowing cost is 10% per annum. Initial direct costs incurred by Manja Bhd are RM1,000.

Required

Calculate the amount that Manja Bhd shall record at the commencement of the lease.

Solution 1

The fair value of the leased asset in this case is RM100,000, the equivalent cash purchase price. The present value (PV) of the minimum lease payments is calculated as follows:

$$PV = \sum_{t=1}^{5} \frac{25,000}{(1+.10)^{t}}$$

- PVIFA(10%, 5) x 25,000
 where PVIFA is the present value interest factor of an annuity
- = 3.791 x 25,000 = RM94,775.

Since the present value of the minimum lease payments is lower than the fair value of the leased asset, the asset shall be recorded at the present value of RM94,775 plus the initial costs of RM1,000, ie total cost of RM95,775.

In practice, and in the absence of grants and tax credits receivable by the lessor, the equivalent cash purchase price can normally be taken as the fair value of the leased asset. Also, in a straight finance lease where only lease rentals are involved, the present value of the lease rentals shall normally be equal to the cash purchase price if the interest rate implicit in the lease is used in the discounting. For a lease of machinery or equipment, it is common to capitalise the leased asset based on the cash purchase price plus initial direct costs without having to test for the lower of fair value and present value.

The leased asset capitalised under the finance lease shall be recorded in the lessee's books based on its nature or use (for example, as a property, plant and equipment) and accounted for in accordance with the policies adopted by the lessee for other assets of a similar nature or use. For example, if the leased asset is classified as property, plant and equipment in accordance with MFRS 116, it shall be depreciated over its useful life if ownership is expected at the end of the lease term. Otherwise, it shall be depreciated over the shorter of the leased term and its useful life.

15.3.1.2 Measurement of finance lease liability and interest allocation

The obligation arising from the finance lease is akin to a long-term financial liability which shall be recognised as such in the statement of financial position, and not as an off-balance sheet financing. At the commencement of the lease, the lease liability shall be recorded at the same amount as the leased asset.

The difference between the sum of the gross lease payments and the fair value of the leased asset represents the total interest or the finance charge which shall be recognised over the lease term. The total finance charge shall be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. In other words, the effective interest rate method shall be applied in the recognition of interest expense in a finance lease. Some form of approximation, such as the "sum-of-digits" method or the "rule-78" method may be used, provided the results approximate the effective interest rate method. The constant periodic rate of interest (ie the effective interest rate of the lease liability from the perspective of the lessee) is not necessarily equal to the interest rate implicit in the lease because the calculation of the latter includes initial direct costs and unguaranteed residual value accruing to the lessor.

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Example 2

Hati Sdn Bhd enters into a finance lease with Lessor Sdn Bhd on 1 January 20x6 for an item of machinery. The terms are as follows:

- lease rental of RM50,000 per year for five years (primary lease period), payable in advance and the first rental is due on 1 January 20x6; and
- lease rental after five years (secondary lease period) is minimal and extends indefinitely.

The useful life of the machine is five years with zero residual value. There is no initial direct cost incurred. The machine could be bought outright for cash of RM200,000. Hati Sdn Bhd adopts a straight line depreciation policy for machinery. Its financial year ends on 31 December.

Required

- Show the journal entry in Hati Sdn Bhd's accounts to record the lease transaction at its commencement;
- Calculate the depreciation required on the leased asset; and
- Record the lease liability and the allocation of the finance charge in each period.

Solution 2

At the commencement date of the lease, Hati Sdn Bhd shall record the lease transaction as follows:

		RM	RM
1 January 20x6:	Dr Machinery under finance lease	200,000	
	Cr Lease liability		200,000

-to record asset and liability at the fair value of the leaved asset.

- At the end of each year, beginning with the year ended 31 December 20x6, the machine under the finance lease would be depreciated at a rate of 20% straight line, ie RM200,000/5 years = RM40,000 per year.
- The total interest charged in the lease is = (RM50,000 × 5) RM200,000 = RM50,000. To produce a constant periodic rate of interest based on the amount outstanding in each period, the effective interest rate in the lease must first be established as follows:

RM200,000 = RM50,000 + [present value of 4 future rentals of RM50,000 each]

RM150,000 =
$$\sum_{t=1}^{4} \frac{50,000}{(1+\tau)^t}$$

where r is the effective rate of interest = 12.6%.

Note that one can easily determine the interest rate by using the IRR formula in a spreadsheet program, such as the Microsoft Excel program, as follows:

Year	Cash flows
0	(150,000)
1	50,000
2	50,000
3	50,000
4	50,000
Set = IRR(Y0:Y4)	12.6%