Financial Reporting Alert

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AUDIT

First impression: Financial impacts of FRS 139

On 1 August 2008, the Malaysian Accounting Standards Board (MASB) issued a press release about its plan to bring Malaysia to full convergence with International Financial Reporting Standards (IFRS) by 1 January 2012.

To facilitate a phased changeover to IFRS, MASB also announced that Financial Reporting Standard (FRS) 139, Financial Instruments: Recognition and Measurement will be effective for financial periods beginning on or after 1 January 2010.

This article aims to provide a first impression on the likely impact of adopting FRS 139 through a desktop review of the latest financial statements of Malaysian companies listed on Bursa Malaysia. The desktop review was based on a sample of 25 listed companies randomly selected amongst the top 100 companies by market capitalisation. We read the financial statements of these 25 listed companies and considered the likely impacts of FRS 139 on the financial assets and liabilities.

Nevertheless, this review excludes financial institutions such as banks and insurance companies because FRS 139 has significant impacts on such institutions.

FRS 139 requirements

FRS 139 generally requires financial assets to be categorised into financial assets at fair value through profit or loss (FVTPL), loans and receivables, held-to-maturity (HTM) investments and available-for-sale (AFS) financial assets. Financial assets at FVTPL and AFS financial assets are measured at fair value at each reporting date, while loans and receivables and HTM investments are measured using the amortised cost model.

Financial liabilities are categorised into financial liabilities at FVTPL and other liabilities. Financial liabilities at FVTPL are measured at fair value at each reporting date, while other liabilities are measured using the amortised cost model.

Financial assets	Fair value model	Armotised cost model
Financial assets at FVTPL	✓	
Loans and receivables		✓
HTM investments		✓
AFS financial assets	✓	
Financial liabilities		
Financial liabilities at FVTPL	✓	
Other liabilities		✓

When financial assets and financial liabilities are measured at fair value, changes in the fair value at each reporting date are recognised in the income statement, except for financial assets classified as available-for-sale.

Amortisation charges or credits arising from accretion in carrying amount under the amortised cost model are also recognised in the income statement in the period they occurred.

Although amortised cost and cost measurement models are not entirely the same, we believe, in most cases, the change will not have a material impact.

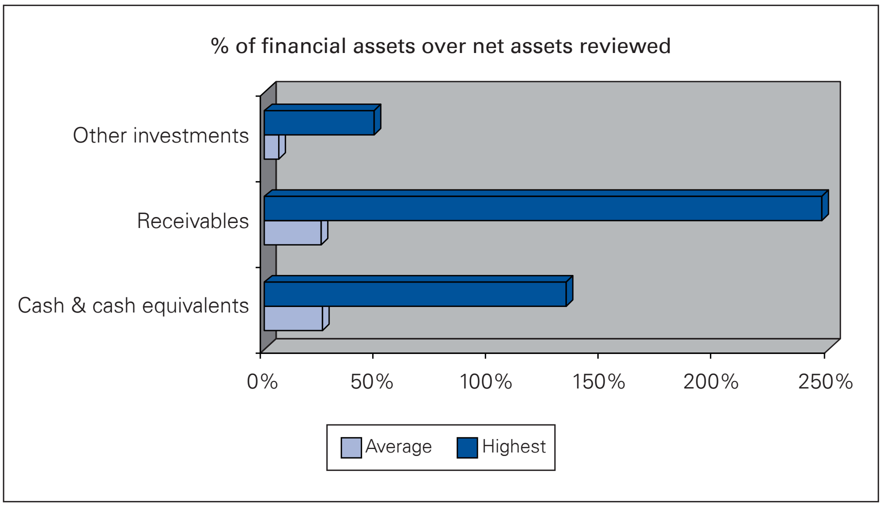
What does the review unveil?

Based on our review of the financial statements of the selected companies, we identified material account balances that will be in the scope of FRS 139. These account balances mainly are:

Financial assets	Financial liabilities
• Investments other than investments in subsidiaries, associates and jointly-controlled entities which are subject to the requirements of other specific FRSs respectively • Receivables • Cash and cash equivalents	• Interest bearing loans and borrowings • Bank overdrafts • Payables

Financial assets

The present accounting standard does not require investments in quoted or unquoted securities to be measured at fair value. Most of the companies reviewed applied the measurement model of cost less diminution in value other than temporary. FRS 139, on the other hand, requires equity investments to be measured at fair value. As for debt investments quoted in active markets (e.g., loan stocks quoted in Bursa Malaysia), we believe that most companies will opt for the fair value model unless they are determined to hold the debt until its maturity, in which case, such debt instruments may be categorised as HTM investments and measured using the amortised cost model.



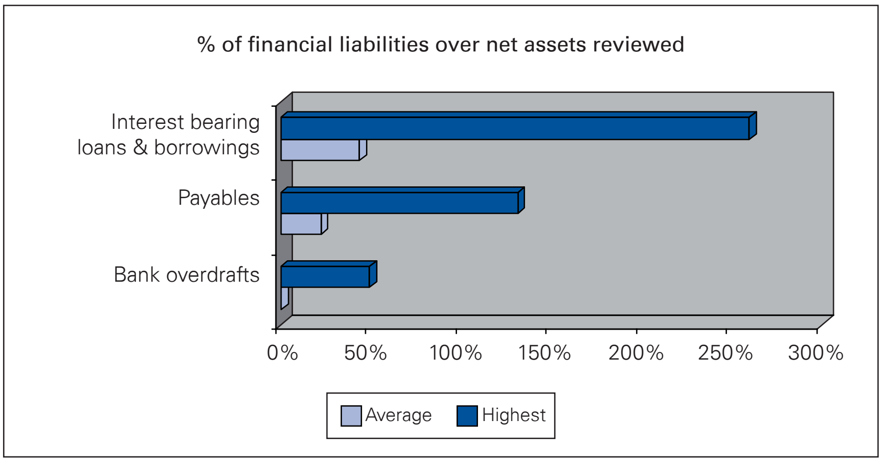
This means that investments in securities will be an area where we can expect most adjustments on the adoption of FRS 139. With the current economic conditions affecting market value of quoted securities, perhaps the adjustments will give a negative impact. However, the effect on the financial position in general is not expected to be material since our desktop review found that such investments only account for an average of 6% of the net assets reviewed. Nevertheless, one of the companies that we reviewed has investment amounting to 48% of its net assets, while five companies have investments above 10% of their net assets. Hence, companies that have huge investments in quoted securities are likely to face material impact.

Receivables account for 25% of the net assets reviewed. We do not expect such financial assets to have significant adjustments on the adoption of FRS 139. Although it is possible for receivables to apply the fair value model on the adoption of FRS 139, this will be rare for non-financial institutions. Most will be expected to measure their receivables using amortised cost model.

As for cash and cash equivalents, which accounts for 25% of the net assets reviewed, we do not expect any impact from the adoption of FRS 139.

Financial liabilities

Interest bearing loans and borrowings account for 44% of the net assets reviewed. Payables account for 22% of the net assets studied and bank overdrafts account for only 1%. We believe all of these financial liabilities will be measured using the amortised cost model on the adoption of FRS 139. On limited circumstances, financial liabilities may be measured using fair value model under FRS 139. However, this will be very rare for non-financial institutions.



Although financial liabilities are generally measured using the cost model presently, we do not expect much difference with the amortised cost model in FRS 139.

Having said this, companies should watch out for loans and borrowings that are not negotiated at arms length basis or where the contracted interest rates are substantially below market rates. This will be prevalent for loans or advances among related companies which will be eliminated when preparing the consolidated financial statements. In our review, we did not cover such loans or advances since our focus is on the consolidated financial statements. Significant adjustments are expected from such loans or advances because FRS 139 principally requires all financial instruments to be measured at fair value on initial recognition.

Off balance sheet financial instruments

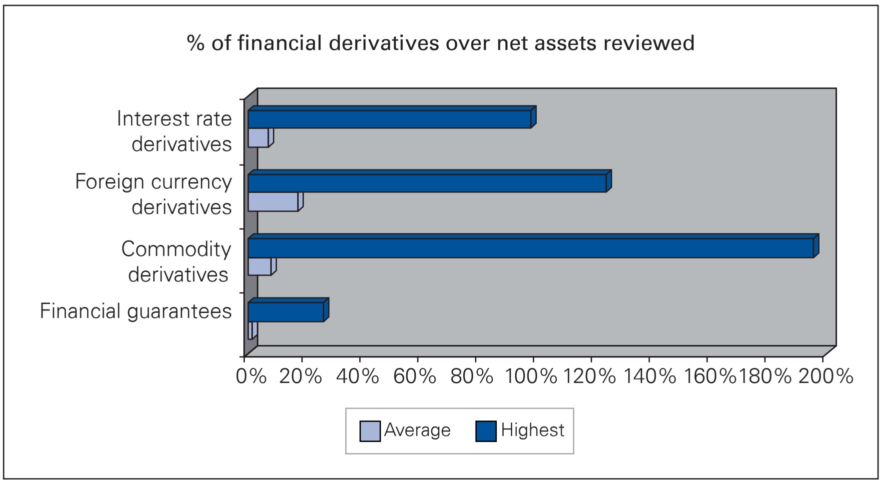
On adoption of FRS 139, many "off balance sheet" financial instruments will be accounted for on the balance sheet. Examples of such financial instruments include interest rate swaps, foreign currency forward contracts, commodity forward contracts (not for own use or consumption) and commodity futures.

FRS 139 requires such financial derivatives to be measured at fair value at each reporting date. Changes in fair value are normally recognised in the income statement unless the financial derivative qualifies for hedge accounting.

We expect to see a lot of adjustments to recognise such financial derivatives on the adoption of FRS 139. This will also create new classes of financial instrument on the balance sheet, normally known as derivative financial asset or derivative financial liability.

Our review found that the contracted nominal values of unrecognised financial derivatives (i.e. off balance sheet) account for 33% of the net assets reviewed. The 33% is represented by 8% of commodity derivatives, 7% of foreign currency derivatives, 17% of interest rate derivatives and 1% of financial guarantees. Nevertheless, only the changes in market prices of such contracts will be accounted for. The impact will be great when the market is volatile, like the current market scenario.

It is very difficult to determine whether these derivatives will eventually give a positive or negative impact to the financial position of these companies. Hence, it is an area to watch out for.



Embedded derivatives

One of the significant areas that is not addressed in our review is the existence of derivatives embedded in normal contracts. For example, a company that enters into a supply contract for crude palm oil that allows the supplier to have a floor price has indirectly written a put option. The put option may need to be accounted for as a standalone derivative.

Embedded derivatives may exist in financial instrument contracts (e.g., loans, leases or convertible loans) or even non-financial instrument contracts (e.g., sale and purchase agreement of properties, supply contracts or forward sale or purchase contracts).

FRS 139 has a lot of rules governing embedded derivatives and at the same time given exemptions to specific situations which are not principle based. This is expected to cause various application issues in practice.

In our opinion, embedded derivative identification is an area that has the highest FRS 139 adoption risk. This could simply be due to lack of understanding of the complicated requirements of FRS 139 or failure to identify derivatives embedded in contracts. Unlike other financial instruments that appear on the balance sheet, it is a daunting task to completely identify derivatives embedded in all contracts. Hence, companies should pay more attention on this area and when needed, to consider involvement of specialists.

As a start, companies should update its records/registers that capture all contracts signed to-date, to facilitate an assessment on the impact of FRS 139. This register allows the company to ascertain completeness of contracts undertaken by the company.

Adoption strategy

We expect the process of adopting FRS 139 to be challenging due to the complexities surrounding its application.

Contrary to popular belief, adoption of FRS 139 does not mean that all financial assets or liabilities will need to be fair valued. From the review above, you will notice that only a handful of account balances will have a significant impact from the standard.

On the surface, there are at least two areas which will be significantly affected by FRS 139 adoption for a non-financial institution:

- investments in securities (equity and debt instruments); and
- off-balance sheet derivatives including embedded derivatives.

Other financial assets or liabilities may also have impacts but we do not expect them to be material.

Unlike other accounting standards, application of FRS 139 may have a profound impact on the accounting system and processes. It may also affect the day-to-day contracting and business activities. It is imperative for a company to start managing the adoption of FRS 139 now.

For a listed company that has a December financial year end, it has less than 17 months to prepare for the adoption of FRS 139; assuming that the first quarter ending 31 March 2010 announcement will be made at the end of 31 May 2010.

17 months seem to be a long period. However, due to MASB's IFRS convergence plan, MASB has issued or will continue to issue more standards and interpretations that may be effective at the same time. For example, FRS 7, Financial Instruments: Disclosures will be effective for financial periods beginning 1 January 2010 and FRS 8, Operating Segments will be effective for financial periods beginning 1 July 2009. Do not underestimate the necessary man-hours to adopt these standards also.

Inadequate project management has proven to be the Achilles' heel of many projects. Management will need to set up an appropriate team and plan for the timely assessment and adoption of FRS 139. Past precedents have indicated late planning or actions will only increase the risk of reporting failure or misstatements.

More information

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