



THE PERCEPTION OF MALAYSIAN PALM  
PLANTATION COMPANIES TOWARDS THE  
ADOPTION OF A PROPOSED STANDARD OF  
AGRICULTURE (IAS 41) IN MALAYSIA

BY

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## **ABSTRACT**

The International Accounting Standard of Agriculture (IAS 41) standard has raised many controversial issues particularly relating to agriculture activities where the income-producing biological assets have long economic lives that stretch beyond ordinary accounting periods. Such biological assets include palm trees, rubber trees, timbers etc. Based on the situation in Malaysia, the standard still needs revision so that it may be extended to include palm trees that are long-lived biological assets. Thus, the main objective of this study is to examine the current accounting method as practised by Malaysian palm plantation companies in relation to palm oil trees, which fall under biological assets. The secondary objective is to examine the Malaysian palm plantation companies' perception towards potential challenges if the IAS 41 is adopted in Malaysia. This study used the multiple case study research approach to note the differences in opinion or perceptions between small and big palm plantation companies. In order to do this, six palm plantation companies were selected and 13 employees from these companies were interviewed. The findings showed most of the palm plantation companies gave negative perspectives regarding the application of the proposed standard. This is due to the complexity of IAS 41; and the absence of fair value market especially for palm oil trees and other long-lived biological asset. However, most of palm plantation companies agreed that this standard is appropriate for short-lived biological assets. Overall, it is hoped that the standard setters will revise the existing agricultural standard and find some practical solutions to the problem of the inactive market in order to ensure that the IAS 41 will be relevant and applicable to all biological assets.

## خلاصة البحث

لقد أثار معيار المحاسبة الدولي الموحد للزراعة (IAS 41) العديد من القضايا المثيرة للجدل، خاصة فيما يتعلق بأنشطة الزراعة التي لديها أصول بيولوجية تدر دخلا يستمر فترة اقتصادية طويلة تمتد خارج فترات المحاسبة العادية. وتشمل هذه الأصول البيولوجية أشجار النخيل، وأشجار المطاط، والأخشاب إلخ. واستناداً إلى الوضع في ماليزيا، فالمعيار يحتاج إلى مراجعة بحيث يمكن تمديده ليشمل أشجار النخيل التي لها أصول بيولوجية معمرة. لذلك، الهدف الرئيس لهذا البحث هو دراسة أسلوب المحاسبة الحالي الذي تمارسه شركات زراعة النخيل الماليزية المتعلقة بأشجار زيت النخيل، والتي تندرج تحت بند الأصول البيولوجية. والهدف الثانوي لهذه الدراسة هو تصور شركات زراعة النخيل الماليزية تجاه التحديات المحتملة إذا تم اعتماد معيار المحاسبة الدولي رقم 41 في ماليزيا. واستخدمت هذه الدراسة منهج دراسة حالات متعددة لملاحظة الاختلافات في الرأي أو التصورات بين الشركات الكبيرة والشركات الصغيرة لزراعة نخيل الزيت. ومن أجل تحقيق ذلك، تم اختيار ست من شركات زراعة النخيل، وأجريت مقابلات مع 13 موظفاً من هذه الشركات. وأظهرت النتائج أن معظم شركات زراعة النخيل لديها نظرة سلبية فيما يتعلق بتطبيق المعيار المقترح. وذلك بسبب الطابع المعقد لمعيار المحاسبة الدولي رقم 41؛ وغياب القيمة التسويقية العادلة لا سيما لأشجار زيت النخيل وغيرها من الأصول البيولوجية المعمرة. ومع ذلك، اتفقت معظم شركات زراعة النخيل على أن هذا المعيار مناسب للأصول البيولوجية ذات الحياة القصيرة. ومن المأمول من واضعي المعايير مراجعة المعايير الزراعية القائمة، وإيجاد بعض الحلول العملية لمشكلة السوق الغير نشط من أجل ضمان أن يكون معيار المحاسبة الدولي رقم 41 ذا صلة وقابل للتطبيق على جميع الأصول البيولوجية..

## APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

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## DECLARATION

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## LIST OF ABBREVIATION

AOSSG WP	Asian Oceanian Standard Setter Group Working Paper
BBA	Bearer Biological Asset
CBA	Consumable Biological Assets
CIMA	Chartered Institute Management Accountants
CPO	Crude palm oil
DCF	Discounted Cash Flow
DSOP	Draft Statement of principle
EU	European Union
ED	Exposure Draft
FASB	Financial Accounting Standard Board
FFB	Fresh Fruit Bunches
FRS	Financial Reporting Standards
GAAP	General Accepted Accounting Principle
IAS 41	International Accounting Standard of Agriculture
IASB	International Accounting Standard Board
IFRS	International Financial Reporting Standards
IFRIC	International Financial Reporting Interpretations Committee
IFRIC 15	Interpretation of 15 Agreements for the Construction of Real Estate
MFRS	Malaysian Financial Reporting Standards
MARC	Malaysian Rating Company
MPOB	Malaysian Palm Oil Board
NPV	Net Present Value
NRV	Net Realisable Value

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.0 INTRODUCTION**

This chapter begins with the background of the study in section 1.1 and 1.2, followed by the statement of the problem, and motivation of the study. The next section will briefly discuss the objectives of the study as well as the research questions and significance of the study. The last section will outline the organisation of the study, followed by the conclusion of the chapter.

### **1.1 DEMAND OF ACCOUNTING STANDARD FOR AGRICULTURAL SECTOR**

Over twenty years ago, agricultural activities mainly took place at small family farms and there were no specific guidelines for the agricultural sector. Marsh, Treba and Fischer (2013) argue that this sector initially received little attention from standard setters and the sector made only a small contribution to the national income. This is because during that time there was no accounting specialty in agriculture, there were poor-quality accountants and agricultural businesses were small (Argiles & Sloy, 2001). Now, times are changing and the agricultural sector is becoming very significant and contributes huge income to agriculture-based economies. Furthermore, accounting policies have moved forward in developing measurements for agricultural accounting. It is believed that agriculture should have its own accounting standard to make its outputs match the current accountancy practices especially in financial reporting. To this end, the International Accounting Standard Board (IASB) has introduced the International Accounting Standard (IAS) 41 to specifically account for

the agricultural sector. In particular, IAS 41 sets out the accounting treatment and disclosures applicable to agriculture produce and activity.

The purpose of IAS 41 is to standardise and to harmonise accounting for agriculture for those dealing with business-level agriculture. It sets out the accounting principles related to agricultural activities such as the measurement of biological assets that are used to produce agricultural products. The standard defines biological assets as any living animals and plants. According to Lazar and Huang (2008), these biological assets refer to plants and animals as well as more specifically latex, palm oil, forestry, plantations, livestock, orchards, floriculture, aquaculture, consumable biological assets and bearer biological assets.

This IAS 41 standard also introduces the fair value concept to replace the historical cost method. According to IAS 41, the use of fair value accounting in agriculture is in harmony with the recent practice of using fair value accounting, and also in the measurement of performance in the financial capital maintenance method. The standard rationalises that fair value provides a more relevant information about the performance of the entity that undertakes agricultural activity than the traditional cost-based measure of profit and loss (Tan, 2010). According to Tan (2010), in the historical cost model, profit and loss are not reported until a sales transaction (realisation) is completed. This is very important in the agricultural context because the cost method records the asset based on the realised sales transaction; therefore in the case of palm oil cultivation it would only be reported 3 to 4 years later, while in the case of rubber cultivation 6 to 7 years later, or it would be progressively measured based on the value changes that occur during the physical process of growth, procreation, degeneration and harvesting where these would be reported in each period during the biological asset's transformation. In other words, the value changes

based on the life cycle and age of the palm trees and rubber trees. Therefore, the International Accounting Standards Board (IASB) believes that the fair value basis could provide a more relevant and reliable measurement of performance in agricultural activities. However, the use of fair value in the agricultural sector raises several issues as shown by the findings in the literature on this subject worldwide and in Malaysia. In this regard, this study focuses on Malaysia and aims to examine the perception of palm plantation companies on the proposed adoption of IAS 41 in Malaysia.

## **1.2 PROPOSED ADOPTION OF IAS 41 IN MALAYSIA**

Agriculture is an important sector to Malaysia. The agricultural industry, especially the palm plantation sector, contributes a huge amount of revenue to the Malaysian economy. According to the Malaysian Palm Oil Board (MPOB, 2014), Malaysia is the world's largest producer of palm oil, producing a yearly output of more than 16 million tonnes of crude palm oil (CPO). In Malaysia, palm plantations are the main agricultural sector. Malaysia is located in Southeast Asia and so it has a humid, tropical climate with numerous endemic, forest-dwelling species making it an ideal place for the cultivation of palm oil (Koh & Wilcove, 2008).

Although Malaysia had fully converged its accounting standards into IFRS in January 2012 (Chan, 2012), two of these standards are problematic for the country. These standards are IAS 41 for agriculture and International Financial Reporting Interpretations Committee (IFRIC) 15 for real estate. This study research will only focus on the agricultural standard.

When Malaysia announced it would converge with the IFRS, it was clear that the agriculture standard would have to be introduced in Malaysia because the



agricultural sector is a major contributor to the Malaysian economy. As one of the countries following the IFRS, Malaysia has to adopt this standard to standardise its financial reporting on agriculture so that it is in line with that of other countries that have adopted the IFRS. Besides being an essential agricultural production material, palm plantation has become the main asset of many other agricultural businesses. For the Malaysian agricultural sector, palm oil is its biological assets. Thus the selection of an appropriate measurement for this key biological asset has become an important issue in agricultural accounting. Due to the importance of this Malaysian's main biological asset (i.e palm tree plantations), the adoption of IAS 41 is being proposed.

This is because issues related to the recognition, measurement and disclosure of biological assets will have a significant effect on the regulation of agricultural companies' accounting treatment as well as on the information disclosure practised by Malaysian agricultural businesses, especially in the palm oil sector.

A palm tree has an economic value for 25 to 30 years. This raises the question, what is the fair value of palm tree with a longer life span that ends up with no market? The issue raised in relation to this fair value measurement is the issue of there being an inactive market for the biological asset of the palm tree itself as well its fruit (Asian Oceanian Standard Setter Group Working Party, [AOSSG WP], 2011). Tan (2010) believes that there is no market as such for biological assets such as palm trees because every biological asset has different phases in their transformation process such as growth, degeneration, production, and procreation that causes qualitative or quantitative changes in the biological asset. For instance, the life span of a palm tree is about 25 years longer than that of other biological assets such as deer, cows, and paddy fields, among others.

As it is generally known, fair value is concerned with two qualitative characteristics of accounting information, namely reliability and relevancy. These characteristics of fair value result in both 'reliable' and 'relevant' measurement. However, the term 'reliability' was changed to 'faithful representation'. It is interesting that the arguments in the Discussion Paper from FASB/IASB (2006) framed for replacing the concept "reliability" with the concept "faithful representation" is connected to the fair value debate.

Reliability was defined as "the quality of information that is free from material error and bias and can be depended upon by users to faithfully represent what it purports to represent" (IASB FW.31 1989; SFAC 2, p. 6 as cited by Wüstemann, 2011). The reliability concept has three components –"representational faithfulness (faithful representation), verifiability and neutrality" (SFAC 2, p. 13). On the other hand, according to Wüstemann (2011) faithful representation refers to transactions and events that are represented faithfully when the way they are accounted for reflects the economic phenomena they purport to represent.

Even though the qualitative characteristics of reliability was changed to faithful representation, there are discussions from the Exposure Draft of Conceptual Framework for Financial Reporting (2015) that stated reliability is very similar to the qualitative characteristics of faithful representation as described in existing conceptual framework and exposure draft (IASB, 2015). However, the IASB believes that the term faithful representation describes these aspects better than the term "reliability" (IASB, 2015). Kinserdal (2011) supports this by stating that FASB/IASB claimed that the change from reliability to the faithful representation is just a "change of wording". At the initial stage, the concept "reliability" is included as a qualitative characteristic in any statement of concepts in the U.S., in SFAC 2. The document (FASB 1980:§59)

states: “the reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user, which comes through verification, that it has that representational quality”. SFAC 2 underlines that reliability is a characteristic that is represented in different degrees; it is a question of whether it is more reliable or less. “Representational faithfulness” and “verifiability” are two qualities of the concept “reliability”. Reliability stems from these two characteristics that are desired to keep them separate as distinct components of reliability.

Besides that, several prior studies still discuss and use the term reliability instead of faithful representation. For example Li and Yun (2013) stated that the value of biological asset will be reliable if it has active market. From the findings obtained in this study, the respondents still discussed the issue of reliability of fair value in biological assets. Although there is an amendment made by IASB in 2015 relating to faithful representation, the concept can still be questionable when the price is unobservable or the value cannot be determined accurately, especially in an inactive market. In fact this has been the problem when reliability was used as a qualitative characteristic. According to Financial Reporting Council (2014), the issues of reliability and its replacement with faithful representation are still being debated. This shows that both the reliability and faithful representation are questionable in an inactive market. This presents a bar for the full application of IAS 41.

As a conclusion, both reliability and faithful representation are similar. The change from reliability to faithful representation occurs because the IASB thinks that faithful representation is more accurate in determining the fair value of a given asset. Nevertheless, the above discussion shows that both the concepts are still questionable

in determining fair value price under IAS 41 when the markets are inactive. Thus, the study focuses on the reliability.

According to Aryanto (2011), when making decisions, it is useful if the accounting information has these two qualitative characteristics. These qualitative characteristics, which are reliability and relevancy, reveal that the fair value measurement in the agricultural sector is indeed a better method as compared to the cost method.

According to Li and Yun (2013), using the cost method for measuring biological assets is although reliable, it results in irrelevant value. The cost method is deemed reliable because it focuses on the actual cost incurred, but it is likely to be less relevant as it is historical and hence, outdated. Arguably, the cost method tends to produce result that does not reflect the true underlying value of assets (Herranz & Osma, 2009). Bohusova, Svoboda and Nerudova (2012) claimed that the historical cost method, when used as a basis for measurement, does not take into account the value added by the biological process. Furthermore, it does not consider the net present value (NPV) as an appropriate basis for the measurement of biological assets either. For instance, if the cost method is used, the value of the biological asset at the end will be zero in terms of book value because of depreciation, but the asset will still have a certain value in the market, which would be apparent if the fair value method were applied.

Therefore, using the fair value method to measure biological assets is seen to be more relevant. However, it has been argued that such a method is not reliable in an inactive market (Li & Yun, 2013). This is because companies will use various methods to determine the fair value in an inactive market. As a result, the accuracy of the value of biological assets value cannot be certified, and the information on the

financial statement of biological assets cannot be compared due to the use of different methods. Thus, the purpose of IAS 41 to harmonise the reporting of biological assets so that companies can be competitive with those in other countries cannot be achieved. In contrast to the fair value market, there is no market for certain biological assets, especially those with a long life span (Bosch, Sabata & Garcia, 2011). For instance, based on a study in India, Beria (2010) claims that the fair value method proposed by IAS 41 is inappropriate to be implemented for agricultural enterprises involving timber trade as there is no active market for timbers. This is because timber has an economic life span of 50 years, which continues beyond one accounting period. Similarly, it is argued that fair value is not an appropriate measurement basis to be used in valuing palm trees as they also have a long time span.

All the issues raised above explain why Malaysia introduced this standard. This is primarily due to the nature of its biological assets – in the context of this study, the assets are the palm trees. Also, in light of the above discussion on qualitative characteristics, it is fair to deduce that both reliability and relevancy are crucial in delivering good accounting information. Thus, in order for the IAS 41 standard to be applied, it is important to ensure that this standard is both relevant and reliable in the present time as well as in the future. Equally important is that the standard should be able to cater the problem of active market regardless of a commodity's life span.

Therefore in this study, the researcher aims to fill a gap in the limited literature available on the Malaysian agriculture, specifically in the palm plantation sector. It also aims to further contribute to an understanding of the issues related to implementing IAS 41 from the perspective of the Malaysian agricultural sector. In addition, this study will particularly focus on the perceptions of Malaysian palm plantation companies on the adoption of IAS 41 in Malaysia.

### **1.3 PROBLEM STATEMENT**

The problem of fair value in the context of this study is that there is no market for palm trees and the fruit growing on the trees. According to Chan (2012), this is why Malaysia is still deferring the implementation of the agricultural standard IAS 41. This statement is supported by AOSSG WP (2011) that discusses the irrelevance of fair value in measuring biological assets because there is no active market price for biological assets such as palm trees. Palm trees have their own biological transformation process which consists of several phases including growth, degeneration, production and procreation. The palm tree's economic life span ranges from 25 to 30 years and it can produce fresh fruit bunches (FFB) three to four times, sometimes more, during its life time (Tan, 2010). However, the problem with using fair value is the non-existence of an active market for long-lived biological assets including palm trees (Beria, 2010).

Due to issues of inactive market, IAS 41 proposes that players can use three bases to deal with this problem. One basis is to compare the market prices of similar products derived from the biological assets (Lazar & Huang, 2008). For example, although there is no market for palm trees or rubber trees, there are commodity prices for their products, CPO and rubber, respectively. However, the comparison of prices in this case is not very accurate and therefore irrelevant. CPO and rubber are the final output commodities, whereas biological assets are the assets that are being used to produce the products, so they are similar in nature to a physical asset. This is supported by AOSSG WG (2011), who said that the comparison of the commodity price for CPO with the value of a palm tree is not very accurate or relevant because CPO is a product of processed palm oil, which was originally obtained from the palm tree itself, whereas the palm tree bears its own fruits, the quantities and qualities of

which differ from tree to tree, making those two values incomparable. Therefore, AOSSG WG (2011) states that the biological assets of palm tree plantations need their own market rather than adopting a way to compare their value to the price of some product that is created from them.

The second basis is that the company may employ an independent evaluator to measure the fair value of a palm tree. This is one of the bases of valuation to determine the fair value (Aryanto, 2011 & Ajith, 2009). Alternatively, they may use the third basis, which is, the present value. In certain circumstances, market-determined prices or values may not be available for a biological asset in its condition at the time. In such circumstances, an entity should use the present value of expected net cash flows from the asset discounted at a current market-determined pre-tax rate in determining fair value (Lazar & Huang, 2008). The cash flows used should reflect the expectation of market participants in respect to the asset in its most relevant market. In the case of bearer biological assets, the present value of expected future cash flow generally represents an ongoing concern regarding the value of all the assets involved in the farming activity (Maina, 2010). As such, fair value might be subjectively arrived at depending on which consultant the company chooses and what basis the company chooses for the determination of fair value. As a result, the fair value obtained might not be relevant and its reliability will be disputed. Moreover, comparison of financial statements with those of companies in the same and in other countries cannot be undertaken because companies can choose a different basis and method to deal with the issue of an inactive market. Using various method may lead to manipulation and subjective judgment in order to obtain a value for their biological assets. This is supported by Aryanto (2011) who studied the use of different measurement models and found that these result in differences in the earnings quality

of the agricultural sector and, as a result, comparability cannot be achieved. Since there is no market price for long-lived biological assets, the reliability of fair value seems to be questionable in terms of providing the true value of a company's assets. Thus, it could result in misleading information for the users of financial statements and cause them to make wrong decisions. Hence, the presentation of all transactions and events is not true and fair in this context.

Consequently, in the case of palm plantations in Malaysia, the fair value obtained for asset valuations is not very appropriate for measuring palm tree assets when there is an inactive market. Fair value is being introduced to harmonise the reporting of biological assets in order that companies can be competitive with those in other countries, but if the standard is not in line with IFRS, that cannot be achieved.

Some of the other issues with IAS 41 include its unclear guidelines for certain biological assets (especially those with long-term economic value), the volatility of the profit and loss accounts due to the fair value valuation, higher cost of valuation and the complexity of the reporting required by IAS 41. As mentioned by Aryanto (2011), the standard is too general and it lacks information on long-lived biological assets that have an inactive market. In addition, the use of fair value may cause profit and loss accounts and the balance sheet associated with biological assets, particularly palm tree plantations, to become volatile, thereby resulting in misleading interpretations, and thus decisions (Aryanto, 2011).

The complexity of IAS 41 and its costly implementation costs is another reason for the IAS 41 to be rejected (Burnside, 2005). For instance, cost valuation when using fair value is difficult because these biological assets have to be valued at each reporting date, leading to a heavy workload for plantation companies as they have to calculate the cost for each hectare of plants within a strict time constraint. As a