Growing pains

Malaysian plantation companies have voiced their concerns about the implementation of a new standard for agriculture, which they claim is unfair

Mention the International Accounting Standard (IAS) 41, *Agriculture* to any Malaysian plantation company and the response is one of apprehension and grave concern.

Local plantation companies say that unless many of the issues relating to the impending implementation of IAS 41 are resolved – in particular, how to fair value biological assets without set guidelines and standardisation to the methodology – then the adoption of IAS 41 will not only be cumbersome and costly but of little value to shareholders and potential shareholders, ironically the very group IAS 41 is supposed to benefit.

Even the Malaysian Palm Oil Association (MPOA) has voiced its concerns, describing IAS 41 as an 'unfair accounting standard' for the plantation and other agriculture businesses in developing countries.

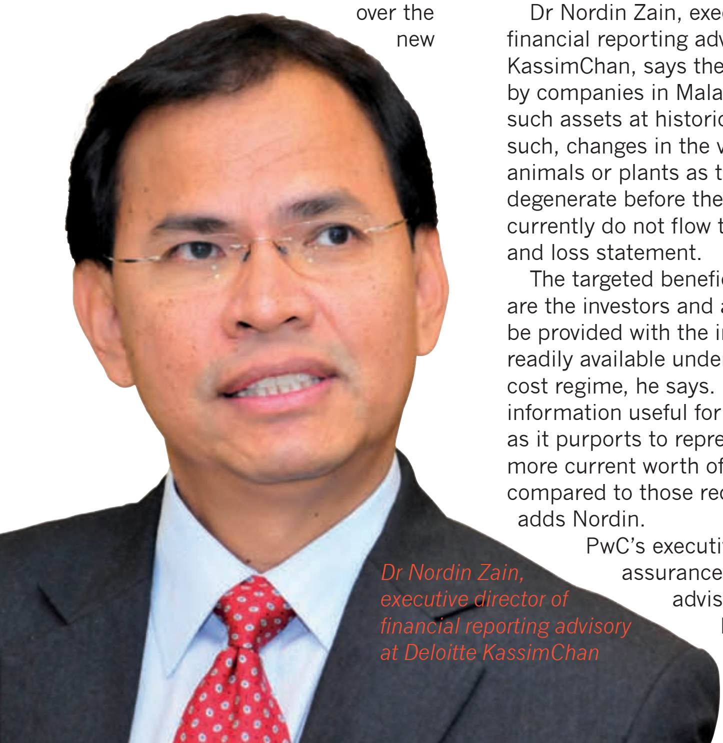
Planters' unease over the new standard has not gone unnoticed; in early September the Ministry of Agriculture and Agro-Based Industry met with plantation companies to seek feedback on the new standard. The government's concern is understandable given that the palm oil sector is one of the pillars of the Malaysian economy.

TH Plantations CFO Mohamed Azman Shah Ishak says there was a consensus among planters present at the meeting, that while the industry is all for fair value accounting, adopting it as it stands is going to 'open up huge room for manipulation'.

IAS 41 requires companies, whether they are in the plantation, livestock or timber industries, to fair value their biological assets at each balance sheet date. By January 2012, Malaysia is set to converge its financial reporting standards with International Financial Reporting Standards (IFRSs), which includes IAS 41.

Dr Nordin Zain, executive director of financial reporting advisory at Deloitte KassimChan, says the current practice by companies in Malaysia is to record such assets at historical costs, and as such, changes in the values of living animals or plants as they grow or degenerate before they are harvested currently do not flow through the profit and loss statement.

The targeted beneficiaries of IAS 41 are the investors and analysts who will be provided with the information not readily available under the historical cost regime, he says. 'They will find information useful for decision-making as it purports to represent a relatively more current worth of the company compared to those recorded at cost,' adds Nordin.



Dr Nordin Zain, executive director of financial reporting advisory at Deloitte KassimChan

PwC's executive director of assurance and business advisory services, Renaka Ramachandran, says the standard will generally aid financial users' understanding and the comparability of financial statements. 'It allows users to compare and contrast the financial statements of agriculture-related companies, not just in Malaysia, but also internationally, when similar assets are measured and reported using the same basis,' she explains.

Determining fair value

Nordin says the main issue clouding the adoption of IAS 41 in Malaysia centres around the fair valuation of biological assets with a long gestation period, particularly for assets in the plantation sector. An oil palm tree, for example, takes four years from field planting to harvesting. With a lifespan of more than 30 years, it has a gestation period of 25

years when its economic value stops.

'The standard requires determination of a value for living plants or animals as they grow or degenerate. Commodities players in Malaysia and in countries where agriculture contributes a significant share of the gross domestic product will find it onerous to fair value the plantation assets, or the trees as they grow given the size of the sector and the geographical locations of the plantations owned by the companies,' says Nordin.

Furthermore, local plantation companies point out that assigning a fair value to the oil palm trees isn't as cut and dried as it's been made out to be. 'How do you assign a value only to the trees while leaving out the infrastructure, buildings and improvements to the land, all of which contribute to the value of a plantation?' asks TH Plantations' Mohamed Azman.

'HOW DO YOU ASSIGN A VALUE ONLY TO THE TREES WHILE LEAVING OUT THE INFRASTRUCTURE?'

What's more, the approach to measure fair value is also problematic, whether one is using the comparison method or the discounted cashflow method. The comparison method, says Mohamed Azman, is difficult given that such data is not easy to come by. 'There are very few transactions, and even these are for smaller tracts of land.'

One is then left with the discounted cashflow method, and here the problem lies with the varying assumptions used such as the yield, selling price and cost, and the volatile nature of those assumptions.

IOI Group finance director Rupert Koh says fair valuation of biological assets involves too many variables and inevitably, the different assumptions used by different plantation companies will make comparisons of fair values difficult and uneven which defeats the purpose of the standard. Mohamed Azman concurs, pointing out that the aim of IAS 41 and fair value accounting is to allow investors to make comparisons. 'But how do you make such comparisons when you don't know how the numbers were arrived at?' he says.

As such, Renaka believes that it's critical that there is sufficient clarity on disclosures in the financial statements of the underlying assumptions used in deriving the fair value of biological assets where comparisons may be made of these key assumptions. 'Using the oil palm plantation segment as an example, these would include key assumptions like selling prices (which is likely to cause volatility in the fair values, and this is especially apparent from fluctuation in prices where crude palm oil prices have ranged from a low of about RM1,500 a tonne to a high of about RM4,200 in the last few years), harvested yields and discount factors used in deriving the fair values from a discounted cashflow model,' she says.

'BOOKING IN PROFITS FOR THE NEXT 25 YEARS UPFRONT IS GOING TO CONFUSE THE INVESTOR'

Open to abuse?

That IAS 41 does not advise or set the methodology for deriving fair value also means that there is potential for abuse, say its critics. MPOA CEO Datuk Mamat Salleh, in a recent report, said management of plantation companies may be tempted to window-dress the values because their rivals may be doing the same thing. Mohamed Azman does not discount such a possibility, given that the assumptions used in deriving fair values lies in the hands of the respective plantation companies.

However, PwC's Renaka believes that, although the standard itself does not specifically set the methodology, it is a given that the assumptions used should be reasonable. 'With appropriate disclosures on these key assumptions allowing comparisons to be easily made, this will ensure that reasonableness and consistency of these assumptions are adhered to.'

She points out that under IAS 41, companies are likely to show a windfall profit (arising from the gain on initial recognition of biological assets at fair value less costs to sell) in the initial year when fair value is determined for the biological assets. However, the profits would be on a decreasing trend in subsequent years, if operations remain static.

The question then is: would such reporting be useful for shareholders and the investing public? Mohamed Azman doesn't think so. 'If I'm a potential investor, I would be looking at profits per hectare and the company's dividend policy… I won't be interested in the company's biological assets. Booking in profits for the next 25 years upfront is also going to confuse the investor who's used to seeing real profits. With the standard, the books will show huge profits but there won't be any dividends because they've not been realised… so what good is the information to the investor?'

Given the potential for abuse, there may be cases where the numbers reported would be fictitious, Mohamed Azman adds. IOI's Koh adds that while the standard will not likely change the way plantation companies do business, he sees the possibility of income statements becoming less reliable.

In addition, critics of IAS 41 say there will be huge costs incurred for carrying out the valuation exercise given the frequency with which it has to be carried out. Valuers, however, say such fees can always be structured, and The Board of Valuers, Appraisers and Estate Agents Malaysia, for instance, can be called on to come up with a scale for such valuation fees.

Deloitte KassimChan's Nordin says with the added pressure of ensuring full convergence with IFRSs by 1 January 2012, the authorities will increase their efforts in ensuring the standard gets the buy-in from all stakeholders. 'Discussions between the Malaysian Accounting Standards Board and the International Accounting Standards Board must continue for a standard that can be successfully implemented.

'Meanwhile, companies must brace themselves if it's to be implemented in its current form. Investment in resources will need to be increased particularly in staff skills, education and training, and systems,' he says.

Nordin adds that planters could learn from international companies that have already implemented IAS 41, particularly those in Australia and Papua New Guinea for timber, and Sri Lanka for tea plantations.

Sreerema Banoo, journalist