

Chapter 6

Convergence with IFRS in Malaysia

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Introduction

We discuss the issues and challenges of the movement to convergence with International Financial Reporting Standards (IFRS) in Malaysia. In reviewing some previous studies of IFRS in Malaysia, we point to directions for future research.

It is widely suggested in the literature that IFRS offer several advantages to the countries that have adopted IFRS or have converged their own standards with IFRS. The advantages include increased transparency and comparability of financial statements, enhanced quality of financial reporting and increased capital market efficiency. However, the standards issued by the International Accounting Standard Board (IASB) have been largely influenced by the institutional characteristics of developed economies. Hence, converging with IFRS in a developing country like Malaysia is not without issues and challenges.

In the case of Malaysia, effort to converge the local accounting standards with FRS started in 2005. In 2008, the country declared its aim to achieve full convergence with IFRS by 1 January 2012. Nevertheless, full convergence was delayed to 2018 due to several outstanding issues that will be discussed later in this chapter (*The Star*, 2015; *Borneo Post*, 2015). This indicates

that the IFRS convergence is hardly a straightforward journey for a developing country like Malaysia.

Overview of financial reporting and disclosure regulation in Malaysia

Historically, Malaysia was under British colonial influence from the 18th century until it gained independence in 1957. With this historical background, the regulation of financial reporting and disclosures in Malaysia has, to a large extent, been influenced by the UK. This influenced the development of the Companies Act and accounting standards.

Prior to the establishment of the Malaysian Accounting Standards Board (MASB) in 1997 accounting standards were issued by two accounting bodies, namely, the Malaysian Institute of Accountants (MIA) and the Malaysian Institute of Certified Public Accountants (MICPA). MICPA is a local professional accounting body that was formed in 1958, whereas MIA, established under the Accountants Act 1967, is a regulatory body that regulates and develops the accounting profession in Malaysia. The accounting standards that were jointly issued by the MICPA and MIA were known as Malaysian Accounting Standards (MASs).

MASB was established under the Financial Reporting Act 1997 with the main objectives of developing and issuing accounting standards in Malaysia. The accounting standards developed by MASB were based on the International Accounting Standards (IAS) with additional guidance and illustrations to enhance understanding and also to ensure

compliance with local laws and regulations. Accounting standards issued by the MASB were recognised as 'approved accounting standards'. The adoption of MASB standards was effective from 1 July 1999. Under this reporting framework the application of MASB standards has the force of law. Compliance with approved accounting standards is required in section 244 of the Companies Act 2016 (formerly known as the Companies Act 1965).

The enforcement of MASB standards was entrusted to three regulatory agencies, namely the Securities Commission (SC), the Central Bank of Malaysia (Bank Negara) and the Companies Commission of Malaysia (CCM). The MIA as an accounting regulatory body has also formed the Financial Statements Review Committee (FSRC) to ensure that accountants in Malaysia to adopt and comply with the approved accounting standards.

Apart from the requirement to comply with MASB's approved accounting standards, financial reporting and disclosure practices of listed companies in Malaysia are also governed by the Companies Act 2016, the Securities Commission Act 1993, the Bursa's Listing Requirements and the Companies Commission of Malaysia (CCM).

The Malaysian Institute of Corporate Governance (MICG) was also formed to deal with corporate governance issues in Malaysia and to promote awareness of corporate governance principles to all corporate participants and investors (Liew, 2007). The Malaysian Code on Corporate Governance (MCCG) which was introduced in 2000 was developed based on the

UK's 'Cadbury Code' and the Hampel report (Mat Zain and Subramanian, 2007). To enhance good governance and disclosure practices among Malaysian companies, the MCCG was revised several times, and the latest revision took place in 2016.

In brief, corporate reporting and disclosure practices in Malaysia were not only governed through legal rules (e.g., the Financial Reporting Act 1997 and Companies Act 2016) but also guidance (e.g., then MCCG). This regulation strategy mirrors that in the UK.

Convergence with IFRS

The initiative to converge with IFRS in Malaysia began in 2005 when the MASB standards were renamed as Financial Reporting Standards (FRS), and the numbering of the standards was matched to those of the IFRS (for example, FRS 1 referred to IFRS 1, and FRS 101 referred to IAS1) (MIA, 2005). Since 2006 the FRS have been made identical to IFRS on a per standard basis (MASB, 2007). To reduce the burden of compliance on private entities that would result from complex IFRS,¹ the MASB introduced the Private Entity Reporting Standards (PERS)² in 2006. Hence, from 2006, there was a two-tier financial reporting framework: the FRS framework and the Private Entity Reporting Standard (PERS) framework.

In 2008, Malaysia declared its intention to achieve full convergence with IFRS by 1 January 2012 and the MASB continued to adopt the IFRS in stages based on the full convergence timeline (MASB, 2008). The MASB described 'full convergence' as 'full compliance' with IFRS, meaning that the FRS had to be made identical to the IFRS both in terms of their content (i.e.

verbatim) and timing of implementation. According to the MASB, the word 'convergence' is used rather than 'adopt' because the issuance of standards in Malaysia involves due process that might take around nine to 15 months and requires compliance with local legislation.

Subsequent to the full convergence announcement in 2008, MASB issued a new accounting framework on 19 November 2011. This was named the Malaysian Financial Reporting Standards (MFRS) framework, which is fully compliant with the IFRS framework (MIA, 2012a). The new MFRS framework became effective for annual reporting periods beginning on or after 1 January 2012, and applied to all non-private entities except entities within the scope of MFRS 141- *Agriculture* or IC Interpretation 15-*Agreements for the Construction of Real Estate*³. Effectively this exemption applied to companies involved in real estate and agricultural activities. These exempted companies were referred to as 'Transitioning Entities' (TEs), where they were allowed to apply the previous FRS framework. In this regard, entities involved in property development and agriculture sector can continue applying FRS 201- *Property Development Activities* and FRS 204 – *Accounting for Aquaculture* respectively until 2017.⁴ The TEs were finally mandated by law to comply with the MFRS framework for annual reporting periods beginning on or after 1 January 2018 (MASB, 2016).

In light of this, as of 1 January 2012, there were three sets of MASB approved accounting frameworks in Malaysia; (1) MFRS framework; (2) FRS framework; and (3) PERS framework (MIA, 2012a). PERS were later replaced with the Malaysian Private Entity Reporting Standards (MPERS) in 2014. MPERS is applicable to all private entities effective for annual reporting

beginning on or after 1 January 2016. Principally, MPERS are mainly word-for-word matching to the *IFRS for Small and Medium-sized Entities* (SMEs) Standard issued by the IASB, except for the requirements relating to property development activities, income tax and some terminology changes.

In summary, due to the issues on MFRS 141- *Agriculture* and IC Interpretation 15-*Agreements for the Construction of Real Estate*, full convergence with the IFRS, that was initially announced to be achieved by 1 January 2012, was delayed to 1 January 2018. This means, all listed companies (including their subsidiaries, associates, and companies jointly controlled by them) and non-listed companies that have applied FRS became compliant with the MFRS framework for financial statements beginning on or after 1 January 2018.

Issues and challenges of IFRS convergence in Malaysia

Previous studies have suggested that many countries envisaged and experienced various challenges in adopting the IFRS (e.g. Larson and Street, 2004; Jermakowicz and Gornik-Tomaszewski, 2006). The most common challenges identified were complexity of certain standards, lack of technical expertise of preparers and auditors, under-developed local capital markets, insufficient guidance for first-time application of the IFRS, lack of practical knowledge on application of standards, cost of convergence and problematic fair value accounting.

Interestingly, some have suggested that the convergence path for Malaysia was comparatively less challenging compared to the paths of other countries attempting convergence or adoption for the first time. The rationale for this argument was that most of the provisions of IFRS had already been incorporated into local accounting standards, hence converging the local standards to IFRS was less burdensome for Malaysia (MIA, 2008).

That said, Malaysia's experience in IFRS-convergence was not without challenges. Apart from the above common challenges, there were three areas that are unique in the context of Malaysia. These refer to 1) the application of MFRS 141- *Agriculture*, 2) the IC Interpretation 15-*Agreements for the Construction of Real Estate*, and 3) the accounting for Islamic financial instruments that has not been given adequate attention but matters significantly to Malaysia as a pioneer country in Islamic finance. These issues are discussed in detail below.

Application of MFRS 141- Agriculture (identical to IAS 41)

In Malaysia, companies involved in agricultural activities had been using historical cost accounting. This practice was in opposition to IAS 41 that requires companies to fair value all types of biological assets.⁵ In this regard, the preparers have voiced their concerns about the absence of active markets for some biological assets, lack of expertise and additional costs involved in order to determine the fair value of biological assets.

Given that Malaysia is one of the largest producers and exporters of palm oil and natural rubber in the world, the adoption of IAS 41 was likely to have a substantial impact on the industry, particularly the plantation companies. The MASB had raised this concern to the IASB,

requesting IASB improve the requirements in IAS 41 and also enhance them for bearer biological assets (BBA) (MASB, 2010). The MASB had been in discussion with the IASB since 2008, and finally, the issue of IAS 41 was added to IASB's Agenda Consultation 2011 and ranked as one of the IASB's high priority projects (MASB, 2016). Consequently, an Exposure Draft ED/2013/8 *Agriculture: Bearer Plants* was issued by IASB for public comment on 26 June 2013, and accordingly the amendments to IAS 41 and IAS 16 for bearer plants were issued on 30 June 2014. Following the amendments of the standards by the IASB, the MASB issued the *Agriculture: Bearer Plants* (Amendments to MFRS116 and MFRS 141) in September 2014 and it became effective for annual reporting periods beginning on or after 1 January 2016 (MASB, 2016).

Given that the effective date for the real estate companies to apply MFRS 15 was 1 January 2018, the MASB had decided that the mandatory effective date to apply the MFRS framework for both agriculture and real estate companies should be the same effective date (MIA, 2014). This was to avoid the TEs (both agriculture and real estate companies) having to use different frameworks for the year 2016 that may have confused the users. In view of this, the TEs were required to apply the MFRS framework for annual reporting periods beginning on or after 1 January 2018 (MASB, 2016).

Application of IC Interpretation 15: Agreements for the Construction of Real Estate

IC Interpretation 15: *Agreements for the Construction of Real Estate* (IC15) is identical to the international interpretation of IFRIC 15 issued by the IASB in 2008. In Malaysia, the primary

business model of the real estate industry is based on the 'sell and build' concept where most houses are sold before they are built.

If Malaysia were to adopt the IC 15 (IFRIC 15), it would significantly affect the real estate industry, as the IC 15 requires that the profits only be recognised on completion of the projects as opposed to the existing practice (i.e. the percentage of completion method or over time). In this regard, the Real Estate and Housing Developers' Association Malaysia (REHDA) had raised a concern to MASB on the implementation of IC15 (MASB, 2011). It was argued that the proposed accounting treatment did not reflect the 'sell and build' business model in Malaysia.

Given that the exposure draft on *Revenue from Contracts with Customers* was initially planned for issue by the IASB in mid-2010, the MASB had decided to defer the effective date of IC 15 from 1 July 2010 to 1 January 2012 (MASB, 2011). This deferment was intended to allow the deliberations on the implementation of IC 15 to continue. It also enabled the examination of the proposed standard on *Revenue from Contracts with Customers* with stakeholders. Following the issuance of IFRS 15 *Revenue from Contracts with Customers*⁶ by the IASB in May 2014, the MASB also issued MFRS 15 *Revenue from Contracts with Customers* in September 2014 with the same effective date as IFRS 15, i.e. effective for annual reporting periods beginning on or after 1 January 2017 (MASB, 2016). In light of this, in January 2015 the Financial Reporting Standards Implementation Committee (FRSIC) of MIA issued a guideline to apply MFRS 15, named as 'FRSIC Consensus 23 Application of MFRS 15- *Revenue from Contracts with Customer on Sale of Residential Properties*' (MIA, 2015). According to the guideline by FRSIC, a revenue arising from the sale of property under development can be

recognised over time in accordance with paragraph 35(c) of MFRS 15 so long as the contracts with customers are governed by Schedule G and Schedule H of the Housing Development Act 1966.

However, in 2015 the MASB decided to defer the effective date to 1 January 2018 given that the effective date to adopt IFRS 15 - *Revenue from Contracts with Customers* had been deferred by the IASB. As a result of this deferral, the real estate companies were permitted to continue applying FRS 201-*Property Development Activities* until 2017. The real estate companies were mandated to apply the MFRS framework effective 1 January 2018 and at the same effective date also, FRS 201 *Property Development Activities* was also replaced by MFRS 15 *Revenue from Contracts with Customers*.

Financial Reporting Standards for Islamic financial instruments

Another important issue for Malaysia's context is the progress in addressing issues associated with accounting and reporting for Islamic financial instruments. The strong influence of Islam in Malaysia has led to the development of local Islamic Capital Markets, Islamic Financial Institutions (IFIs) and Islamic financial instruments. Malaysia is known globally as the market leader for *Sukuk* (i.e., Islamic structured securities) and has the world's largest market for these financial instruments (Ali, 2012). *Murabahah*-based instruments are more commonly used by IFIs and corporate firms compared to other Islamic instruments (Minhat and Dzol Karnaini, 2016).

In principle, Islamic financing instruments do not contain interest (i.e. *riba*) which is prohibited. For example, a *murabahah*-based financing envisages that an Islamic bank to purchase an asset (e.g., property) and sell it onward to a consumer for a profit. In principle, this has to be a genuine and real trading (i.e., buy and sell) activity, whereby the parties in the transaction will bargain on a margin of profit (or mark-up) over the known cost of the underlying asset. This means that the buyer-seller relationship in *murabahah*-based trading is supposed to be distinguishable from the straightforward lender-borrower relationship that forms interest-based conventional bank financing.

However, in applying IFRS 9-*Financial Instruments* (an equivalent of MFRS 9), profit earned by a bank under a *murabahah* contract could be viewed as being akin to interest, and therefore would be accounted for as interest revenue. This ‘substance over form’ approach dismisses the real trading notion envisaged for *murabahah*. It also portrays *murabahah*-based trading as if it is tantamount to an interest-based lending activity. It is questionable whether the intended ‘Islamic’ trading element of *murabahah*-based financing is fairly reported if it is treated as akin to interest-based borrowing (Minhat and Dzolkarnaini, 2018).

The view of the MASB is that the MFRS framework can be applied to IFIs in the same way that they apply to conventional financial institutions (MIA, 2012b). However, as illustrated above, an improper accounting treatment denies the distinctive characteristics of Islamic financial instruments and the need for IFIs to be seen as following *Shariah* (i.e. Islamic law) requirements. Treating Islamic financial instruments as akin to interest-based financing is surely against the will of Muslim stakeholders. This poses a question on whether adapting the IFRS is proper in accounting for Islamic financial instruments.

Studies of IFRS in the context of Malaysia

This section provides a review of selected previous studies,⁷ grouped under several themes, in the context of Malaysia. A summary of these prior studies is presented in Table 6.1.

Drivers of, and barriers to, IFRS convergence

Following the announcement by the MASB of its intention to achieve full convergence with IFRS, several studies have been conducted to examine the drivers of, and barriers to, IFRS convergence in Malaysia (e.g. Yapa et al., 2011; Phang and Mahzan, 2013; Tan et al., 2007). Findings from previous studies suggest that coercive isomorphism from stakeholders is the main driver of IFRS convergence in Malaysia (e.g., Yapa et al., 2011; Phang and Mahzan, 2013). Studies also point out that the main internal barriers to IFRS convergence include inadequate knowledge and skills to apply new standards, lack of IFRS training, lack of communication and dissemination of IFRS knowledge to stakeholders and inadequate time to understand new standards.

Challenges and benefits of IFRS adoption

Survey questionnaires were employed by prior studies to examine the perceptions of accounting practitioners in Malaysia on these aspects (e.g. Joshi et al., 2016; Jaafar Sidik and Abd Rahim, 2012). These studies have generally reported that the complexity of the new standards, difficulty in digesting the standards and costly adoption are amongst the challenges faced by the respondents. Despite these challenges, the prior studies reported that the respondents supported IFRS adoption and perceived that the new standards help to improve comparability and transparency in reporting.

Impact of IFRS adoption

Several studies have examined the impact of IFRS adoption in Malaysia (e.g. Marzuki and Abdul Wahab, 2016; Wan Ismail et al., 2013; Yaacob and Che Ahmad, 2012a; 2012b). The findings of these studies generally suggest that 1) higher quality of reported earnings is associated with IFRS adoption, 2) IFRS have enhanced earnings conservatism, and 3) audit fees and audit delay have increased after IFRS adoption.

Compliance with IFRS disclosure

Many previous studies in Malaysia have examined the extent of compliance with IFRS mandatory disclosure requirements and factors that are associated with the level of compliance (e.g. Abdul Rahman and Hamdan, 2013; Abdullah et al., 2015; Carlin et al., 2009; Othman and Ameer, 2009). The findings of these studies vary depending on the sample size, the nature and number of standards they examined and the subjectivity involved in scoring the disclosure levels.

Overall, studies documented low levels of compliance with IFRS disclosure requirements in Malaysia, while findings on the factors associated with compliance levels are mixed. Given that compliance with IFRS is mandatory, the findings of low level of compliance with IFRS poses a question as to the effectiveness of regulatory enforcement in Malaysia.

Studies also highlight that auditors sometimes issue an unqualified or clean audit report despite incidence of non-compliance with accounting standards (e.g. Abdullah et al., 2013). Based on interviews with auditors, Abdullah et al. (2017) suggest that materiality and true

and fair view could be the reasons for issuing a clean audit report despite non-compliance with accounting standards.

Value relevance of accounting information under IFRS

The value relevance of IFRS-based accounting information is currently under-studied in Malaysia and findings are somewhat inconclusive. For example, a study that was based on a property-sector sample found that under the IFRS regime, only book value is value relevant for decision making whereas earnings are not (Kadri et al., 2009). A study using a larger sample size found that both book value and earnings are value relevant under the IFRS regime (Lau, 2010).

Another study finds no evidence that mandatory IFRS disclosure levels are value relevant (Abdullah et al., 2015). According to Abdullah et al. (2015) there are plausible reasons to suggest that compliance with IFRS disclosure requirements may not affect the market value of companies in Malaysia. First, the dominance of family-controlled firms in Malaysia serves as a conduit for the market to be informed more efficiently through private communication channels rather than (IFRS-based) public disclosure. Second, the net effect of a disclosure on firm's value may be negligible due to market's mixed reaction (i.e., positive and negative effects). Third, high non-compliance levels, especially for standards that attract high proprietary costs, means relevant information remains undisclosed. Future research in this area should consider the distinctive characteristics of Malaysia's capital market to shed a better understanding of the relevance of IFRS-based disclosure.

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Future directions

First, the internationalisation of financial reporting standards has undoubtedly introduced challenges based on convergence or adoption in Malaysia. Most of the challenges identified so far in research studies have been based on the perceptions of accountants and auditors. Challenges as perceived by different groups of stakeholders might be different, but are largely unknown. Therefore, it is suggested that future studies revisit the issue by surveying the perceptions of different groups of stakeholders such as financial analysts, institutional investors, lenders and regulators. Considering different perspectives will enable researchers to gauge a holistic view of the challenges associated with IFRS adoption in order to formulate a meaningful feedback to improve regulation if need be.

Second, it is also observed that, while some research has used surveys, questionnaires or interviews, to gather perceptions of IFRS convergence or adoption, most studies have used quantitative research approaches based on accounting data or market data to examine IFRS-related issues. The issues examined include compliance with the IFRS and impact of the IFRS on stakeholders. There is a view that the quantitative research approach is rather limited in its ability to explain the 'why' aspect of an observation. The extant literature on IFRS can be enriched exploring further the 'why' aspect through using qualitative research approaches that may involve interviews, case studies and other methodologies.

Third, it is also inferred from the findings of previous studies that adequate and effective training has to be in place to support the introduction of new standards. In this

regard, to what extent the principle of fair value accounting, particularly MFRS 9, has been understood and properly applied by companies has yet to be explored. Furthermore, future research can also explore the impact of MFRS 141 and MFRS 15 on the plantation and real estate industries in Malaysia. It would also be interesting to know how the plantation companies and 'sell and build' property companies in Malaysia cope with the requirements imposed by the MFRS.

Fourth, exploring the challenges and issues associated with applying the IFRS to accounting for Islamic financial instruments is an interesting avenue for future research. This research agenda is particularly relevant to Malaysia, which has been promoting the use of Islamic financing to support the government's ambitious plan for economic growth. The Islamic Financial Services Board (IFSB) estimated that the Islamic Finance industry grew annually at a rate of 17% between 2009 and 2013. Failing to accommodate the need to account for Islamic financial instruments as non-interest bearing instruments risks the reputation of the industry and regulators as stakeholders are becoming more sophisticated. Therefore, research to pre-emptively tackle this issue is important to address reputational risk.

Finally, the adoption of IFRS to account for Islamic financial instruments remains a subject of interesting debate and research. Effective deliberation on this topic requires competency in accounting, finance and Islamic finance. The risk of 'capture' for commercial interest is possible if competency and integrity are lacking. To what extent the voice of experts at MASB has been considered in deliberating the accounting rules for Islamic financial instruments at

international level is questionable. These instruments are generally accounted for as interest-based instruments, and often regarded as interest-based instruments in legal and commercial disputes. Taking Malaysia as a pioneer of the Islamic finance industry, Malaysian regulators are responsible to lead and steer the current practice to the right direction. In our view, this is the greatest challenge to be shouldered by MASB forward to protect the public interest.

Notes

¹ A private entity is defined in the Companies Act 2016 (section 2) as a private company that; (i) is not required to prepare or lodge any financial statements under any law administered by the Securities Commission Malaysia or Bank Negara Malaysia; and (ii) is not a subsidiary or associate of, or jointly controlled by, an entity which is required to prepare or lodge any financial statements under any law administered by the Securities Commission Malaysia or Bank Negara Malaysia.

² Fundamentally, PERS were MASB standards issued by the MASB prior to 1 January 2005. PERS were much simpler than FRS because the standards were not affected by revisions and requirements of IFRS. The private entities have the option to apply in its entirety, either the PERS or FRS which is mandatory for non-private entities, if they deemed the FRS Framework to be more appropriate for them.

³ MFRS 141 and IC Interpretation 15 are identical to IAS41 and IFRIC 15 issued by the IASB.

⁴ The TEs were initially expected to apply the MFRS framework beginning on or after 1 January 2013 (MASB, 2011). The rationale for delaying the adoption date for TE was to accommodate possible changes in IAS 41 and IC 15. Nevertheless, the mandatory effective date for the TEs to apply MFRS framework has been deferred several times i.e., from the first deferment date of 1 January 2013 to 1 January 2017 and then to 1 January 2018.

⁵ That said, there are special conditions for rebuttal of the fair value presumption where fair value cannot be measured reliably.

⁶ IFRS 15 superseded IAS 18 *Revenue*, IAS 11 *Construction Contracts*, IFRIC 15 and related interpretations.

⁷ Our review covers empirical studies that are either open access or accessible via google scholar and research gate as at 28 February 2018. We used the following keyword search; IFRS, FRS, MFRS, Malaysia.

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Editor's note: Table 6.1 is in a separate file