



Technical e-Newsletter

AUGUST 2006 ISSUE

A Monthly e-Newsletter published by the Technical Support Unit of AXP Solutions Sdn. Bhd. (693866-X)

COVER STORY

An overview of the Construction Sector in Malaysia

COMPLIANCE CHECKLISTS & SAMPLE DISCLOSURE NOTES

FRS 111₂₀₀₄

Construction Contracts

FRS 201₂₀₀₄

Property Development Activities

TECHNICAL DIAGNOSTIC CENTRE

- ✓ *Financial Reporting by A Foreign Branch*
- ✓ *Treatment of Rental Income Received From Completed Property of A Property Developer*

free

AXP Useful Templates

Construction Contract Template
Property Development Template
Income Taxes Template



From the Editors ~ Budget Day

Welcome, readers!!

Again, the most anticipated event of the year by the business community in Malaysia - the Budget Day on 1st September 2006, is near at hand. This year, many place high hopes on the reduction of the corporate and personal tax.

Even the tax experts predict so by reference of certain encouraging factors. For example, the increase of government's income tax revenues from:

- (i) petroleum companies as a result of the hike of crude oil price;
- (ii) plantation companies due to the favourable prices for crude palm oil and natural rubber; and
- (iii) construction sector and its supply chain revitalised by the Ninth Malaysia Plan.

Some even give the credit to better education towards tax compliance, more user-friendly means of tax reporting and more stringent field audits and investigation activities. Furthermore, the Malaysian government may also consider to reduce corporate tax rate from the perspective of regional competitiveness.

On the contrary, some professionals may opt for a less optimistic view as they think that tax rate reduction will only happen right before the general elections, or when the GST is implemented. Another factor which is against the tax reduction is: WE ARE STILL IN BUDGET DEFICIT!

Whatever it is, we just need to keep our finger cross and hope that the 2007 Budget will adopt a more pro-business and pro-growth approach.

In this issue of our *e*-Newsletter, we shall continue analyzing two more FRSs, namely [FRS 111₂₀₀₄ Construction Contracts](#), and [FRS 201₂₀₀₄ Property Development Activities](#). In order to help you understand and comply with these two FRSs, we have developed two useful templates for your use.

We've also taken the initiative to design a comprehensive yet useful template for the income taxes. We sincerely hope that all of these templates would be able to assist you in one way or the other.

What's more, we are also proud to introduce to you our new setup at Cyberjaya, Selangor so to serve our clients better. Please feel free to contact us at 03-8315 6168 to find out more on us.

The [Compliance Checklists](#) and the [Sample Notes to the Financial Statements](#) illustrated in this *Technical e-Newsletter* are also available in Microsoft Word and Excel. Please feel free to contact us at enquiry@myAXP.com if you wish to obtain these complimentary copies.

Editors
AXP Technical *e*-Newsletter
August 2006

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Contributions & Comments

AXP Technical e-Newsletter welcomes your contributions on contemporary issues encountered by the profession. We also wish to hear from you on how this e-Newsletter can be improved for more timely and useful information. Your contributions or comments may be sent directly to us at:

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COVER STORY: AN OVERVIEW OF THE CONSTRUCTION SECTOR IN MALAYSIA

Background of the Construction Sector

Construction sector is a key driver for the Malaysian economy. Nevertheless, since the second quarter of fiscal year 2004, the construction sector has recorded negative growth rates.

The following is a summary of Gross Domestic Product (GDP) by Sector for fiscal years from 2004 (actual), 2005 (estimate) and 2006 (forecast) which is extracted from the Economic Report 2005/2006 issued by the Ministry of Finance:-

	Change (%)			Share of GDP (%)			Contribution to GDP growth (percentage point)		
	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²
Agriculture ³	5.0	4.8	5.0	8.5	8.5	8.4	0.4	0.4	0.4
Mining	3.9	1.5	4.7	7.0	6.7	6.7	0.3	0.1	0.3
Manufacturing	9.8	4.8	4.9	31.6	31.5	31.3	3.0	1.5	1.5
Construction	-1.5	-1.1	3.0	2.9	2.7	2.7	-0.1	0.0	0.1
Services	6.8	5.8	6.1	57.4	57.8	58.1	3.9	3.3	3.5
Less imputed bank service charges	3.4	3.9	3.9	9.3	9.2	9.1	0.3	0.4	0.4
Add import duties	-5.4	2.7	0.2	2.0	2.0	1.9	-0.1	0.1	0.1
GDP	7.1	5.0	5.5	100.0	100.0	100.0	7.1	5.0	5.5

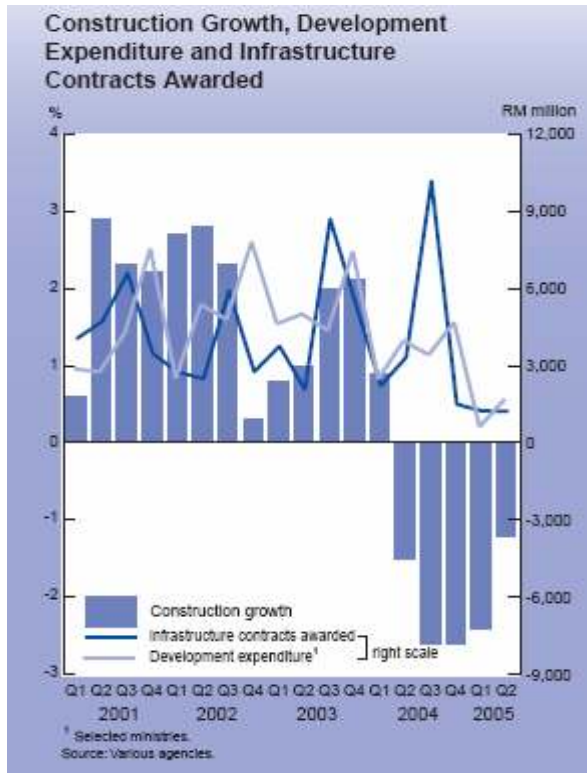
¹ Estimate.
² Forecast.
³ Includes livestock and horticulture.

Source: Department of Statistics, Malaysia.

Source: Malaysia Economic Report 2005/2006

For the fiscal year 2005, the construction sector in Malaysia is envisaged to record a smaller decline of 1.1% in comparison to a decline of 1.5% in fiscal year 2004, following some improvement in civil engineering activities. The construction sector is forecasted to improve further to return to black with a positive growth of 3.0% in fiscal year 2006.

For the purposes of the reporting of GDP, construction sector is principally divided into four sub-sectors, i.e., civil engineering, residential, non-residential and property transactions.



Source: Malaysia Economic Report 2005/2006

As of 11 August 2006, there are 160 companies (approximately 18% of the total Main Board and Second Board counters) listed on the Bursa Malaysia are classified under construction and property sectors, in which 141 counters and 19 counters are listed on the Main Board and Second Board respectively.

Source: www.bursamalaysia.com

Financial Reporting Issues

The key financial reporting issues of the construction and property sectors are as follows:-

1. Allocation of revenue and expenses to the correct accounting period;
2. Accounting treatments for the foreseeable losses from the projects; and
3. Accounting treatments for changes in estimated revenues and costs.

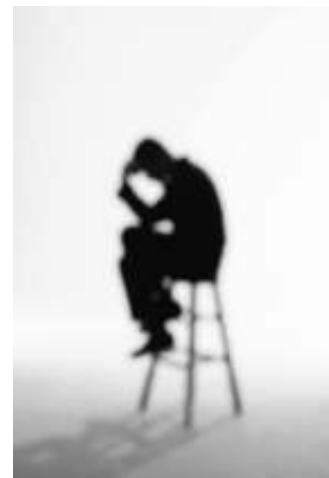
In addition, property development sectors have the following issues:-

1. Recognition and presentation of land held for development;
2. Allocation of development costs relating to the common infrastructures (which may be related to future development activities); and
3. Timing for the recognition of sales concluded at various development stage, etc.

Topics Covered in This Issue

In this issue of the AXP Technical *e*-Newsletter, we focused on the financial reporting requirements of the construction and property sectors, i.e., sample notes and compliance checklists which are complied with FRS 111₂₀₀₄ and 201₂₀₀₄. In addition, we have also incorporated two flow charts for these two FRS to enable you to have a quick reference on the requirements of the FRS.

What's more!! We have also designed two useful templates to facilitate the computation and recognition of revenue and expenses for construction contracts and property development activities. These templates will also automate the disclosure notes. We hope that you will find these templates useful.



Property Development and Construction Contract Issues ~ Tax Perspective

Inland Revenue Board (IRB) has on 13 March 2006 issued **Public Ruling No. 3/2006 Property Development & Construction Contracts** to deal with various issues on the property development and construction contract activities, including:-

1. Date of commencement of business and completion of projects, and the related tax treatments;
2. Method of revenue and profit recognition accepted by the IRB;
3. Estimated losses;
4. Revision of estimates and tax computations;
5. Revocation of sales;
6. Allowable expenses under the Income Tax Act 1967;
7. Valuation of inventories;
8. Tax treatments for the transfer between accounts, for instance, completed properties transferred to inventories or investment properties, etc; and
9. Other issues.

AXP Technical *e*-Newsletter will not specially analyse the public ruling in details. However, this public ruling may be used to answer any technical questions you might have in the **AXP Technical Diagnostic Centre**.

SAMPLE NOTES TO THE FINANCIAL STATEMENTS

COMPLYING WITH *FRS 111*₂₀₀₄ AND *FRS 201*₂₀₀₄



AXP Technical e-Newsletter August 2006 Issue

FRS Ref.

101.46(a)

BE EFFICIENT SDN BHD (Company No. 12345678-A)

101.8(a)

BALANCE SHEETS

101.46(b),(c)

AS AT 31 DECEMBER 2006

FRS Ref.		Note	THE GROUP		THE COMPANY	
			2006 RM'000	2005 RM'000	2006 RM'000	2005 RM'000
101.46(d),(e)						
101.51	NON CURRENT ASSETS					
101.68(a)	Property, plant and equipment	5				
101.68(b)	Investment property	6				
201.51	Land held for development	7				
101.68(c)	Goodwill	8				
101.68(c)	Other intangible assets	9				
101.68(e), 128.38	Investment in associates	11				
101.69	Other investments	13				
101.68(n), .70	Deferred tax assets	14				
101.69	Derivative financial instruments	15				
			-	-	-	-
101.51	CURRENT ASSETS					
201.51(c)	Property development costs	16				
101.68(g)	Inventories	17				
101.68(h)	Trade and other receivables	18				
111.43(a)	Gross amount due from customers	19				
201.50(d)(i)	Accrued billings					
101.69	Other investments	13				
101.69	Derivative financial instruments	15				
101.68(i)	Fixed deposits with licensed banks	20				
101.68(i)	Cash and bank balances	21				
101.68A(a)	Assets held for sale	22				
			-	-	-	-
101.51	CURRENT LIABILITIES					
101.68(j)	Trade and other payables	23				
111.43(b)	Gross amount due to customers	24				
201.50(d)(ii)	Progress billings					
101.68(m)	Current tax liabilities					
101.69	Hire purchase payables	25				
101.68(i)	Bank overdrafts	26				
101.69	Other bank borrowings	26				
101.68(k)	Provisions	27				
101.69	Derivative financial instruments	15				
101.68A(b)	Liabilities directly associated with assets held for sale	22				
			-	-	-	-
	NET CURRENT ASSETS		-	-	-	-

EXTRACTS OF NOTES TO THE FINANCIAL STATEMENTS:

FRS Ref. **3. Significant Accounting Policies**

Construction Contract

- 111.40(c) When the outcome of a construction contract activity can be estimated reliably, contract revenue and contract costs associated with the construction contract are recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date.
- 111.40(d) Stage of completion is determined based on the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs.
- 111.40(c) When the outcome of a construction contract cannot be estimated reliably, contract revenue are recognized only to the extent of contract costs incurred that it is probable will be recoverable and contract costs are recognized as an expense in the period in which they are incurred.
- 111.40(c) Contract revenue also includes variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they can be measured reliably.

An expected loss on the construction contract is recognized as an expense immediately.

Property Development Activities

Land held for property development is carried at cost less any accumulated impairment losses and classified as non-current asset where no development activities are carried out or where development activities are not expected to be completed within the normal operating cycle.

Property development costs comprise all costs that are directly attributable to development activities including costs associated with the acquisition of land, costs related directly to a specific property development activity and costs attributable to the development activities in general and can be allocated to the project.

- 201.50(a) When the development and construction activities commenced and the financial outcome of the development activities can be reliably estimated, property development revenue will be recognized for the development unit sold and determined by reference to the stage of completion of the development activity at the balance sheet date. Stage of completion is determined based on the proportion that property development costs incurred for work performed to date bear to the estimated total property development costs.

When the outcome of a property development activity cannot be estimated reliably, property development revenue are recognized only to the extent of property development costs incurred that it is probable will be recoverable and property development costs are recognized as an expense in the period in which they are incurred.

An expected loss on the property development activity is recognized as an expense immediately (including costs to be incurred over the defects liability period).

Inventories of unsold completed development units are stated at the lower of cost and net realisable value. Net realisable value represents the estimated selling price less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

7. Land Held For Development

		THE GROUP		THE COMPANY	
		2006	2005	2006	2005
		RM'000	RM'000	RM'000	RM'000
<u>Cost</u>					
201.51(a)	At beginning of the year				
201.51(a)(i)	Additions				
201.51(a)(ii)	Disposals				
201.51(a)(iii)	Transferred to property development costs				
201.51(a)	At end of the year				
<u>Accumulated impairment losses</u>					
201.51(a)	At beginning of the year				
201.51(a)(iv)	Charges for the year				
201.51(a)(iv)	Reversal				
201.51(a)	At end of the year				
<u>Carrying amounts</u>					
201.51(a)	At beginning of the year				
201.51(a)	At end of the year				
201.52(b)	Land held for development with carrying amounts of RM___ (2005: RM___) were pledged to licensed banks to secure banking facilities granted to the Group and the Company:				

16. Property Development Costs

		THE GROUP		THE COMPANY	
		2006	2005	2006	2005
		RM'000	RM'000	RM'000	RM'000
201.50(c)(i)	At beginning of the year:- Land Development costs				
Add:-					
201.50(c)(iv)	Transfer from land held for development				
201.50(c)(ii)	Development costs incurred during the year				
Less:-					
201.50(c)(iv)	Completed properties transferred to inventories				
201.50(c)(iii)	Costs recognized as expenses in income statements:-				
201.50(c)(iii)	Prior years				
201.50(c)(iii)	Current year				
201.50(c)(i)	At end of the year				
201.50(c)(i)	Property development costs at end of the year represent:- Land Development costs				

201.52(b) Land held for development with a net carrying amount of RM___ (2005: RM___) were pledged to licensed banks to secure banking facilities granted to the Group and the Company:

102.36(b) **17. Inventories**

	THE GROUP		THE COMPANY	
	2006	2005	2006	2005
	RM'000	RM'000	RM'000	RM'000
At cost:				
Raw materials				
Work-in-progress				
Finished goods				
201.48 Unsold completed development units				
At net realizable value:				
Finished goods				

102.36 (h) Inventories with a carrying value of RM ___ and RM___ have been pledged to a licensed bank for bank facilities granted to the Group and the Company respectively.

111.44 **19. Gross Amount Due From Customers**

	THE GROUP		THE COMPANY	
	2006	2005	2006	2005
	RM'000	RM'000	RM'000	RM'000
111.41(a) Aggregate contract costs incurred to date				
111.41(a) Add: Attributable profits recognized				
111.41(a) Less: Expected losses recognized				
Less: Progress billings				
111.41(c) Retentions included in trade receivables				

21. Cash and bank balances

	THE GROUP		THE COMPANY	
	2006	2005	2006	2005
	RM'000	RM'000	RM'000	RM'000
Cash on hand and at bank				
Cash at bank held under Housing Development Account				

Cash at bank held under Housing Development Account are opened and maintained under Section 7A of the Housing Development (Control and Licensing) Act 1966.

132.60(a) **23. Trade and Other Payables**

	THE GROUP		THE COMPANY	
	2006 RM'000	2005 RM'000	2006 RM'000	2005 RM'000
101.74	Trade payables			
101.74	Other payables and accruals:			
	- Other payables			
	- Accruals			
111.41(b)	- Advances received from contract customers			
101.74	Amounts due to subsidiaries:			
	- trade nature			
	- non-trade nature			

111.45 **24. Gross Amount Due To Customers**

	THE GROUP		THE COMPANY	
	2006 RM'000	2005 RM'000	2006 RM'000	2005 RM'000
111.41(a)	Aggregate contract costs incurred to date			
111.41(a)	Add: Attributable profits recognized			
111.41(a)	Less: Expected losses recognized			
	Less: Progress billings			
111.41(c)	Retentions included in trade receivables			

37. Revenue

	THE GROUP		THE COMPANY	
	2006 RM'000	2005 RM'000	2006 RM'000	2005 RM'000
118.36(b)(i)	Sales of goods			
118.36(b)(ii)	Rendering of maintenance services			
111.40(a)	Contract revenue			
201.50(b)	Property development revenue			
118.36(b)(iii)	Interest income			
118.36(b)(iv)	Royalty income			
118.36(b)(v)	Dividend income			
140.75(f)(i)	Property rental income			

38. Profit before tax

		THE GROUP		THE COMPANY	
		2006	2005	2006	2005
		RM'000	RM'000	RM'000	RM'000
2.51(a)	Value of services rendered by employees for issue of share options				
101.93	Depreciation of property, plant and equipment				
101.93	Employees benefit expenses				
102.36(d)	Cost of inventories recognized as expense				
102.36(e)	Inventories written down to net realizable value				
102.36(f)	Reversal of inventories written down*				
111.40(b)	Contract costs recognized				
201.50(b)	Property development costs recognized				
116.74(d)	Compensation for impaired property, plant and equipment				
118.36(b)(iii)	Interest income from bank deposits				
118.36(b)(v)	Dividend income from other investment				
121.52(a)	Exchange loss (gain):-				
	- Realised				
	- Unrealised				
136.126(a)	Impairment losses, included in other expenses, of:-				
	- goodwill				
	- property, plant and equipment				
136.126(b)	Reversal of impairment losses, included in other operating income, of:-				
	- property, plant and equipment				
138.126	Research and development costs				
138.118(d)	Amortization of other intangible assets included in:				
	- cost of sales				
	- other expenses				
	Direct operating expenses arising from investment properties:				
140.75(f)(ii)	- that generated rental income				
140.75(f)(iii)	- that did not generate rental income				

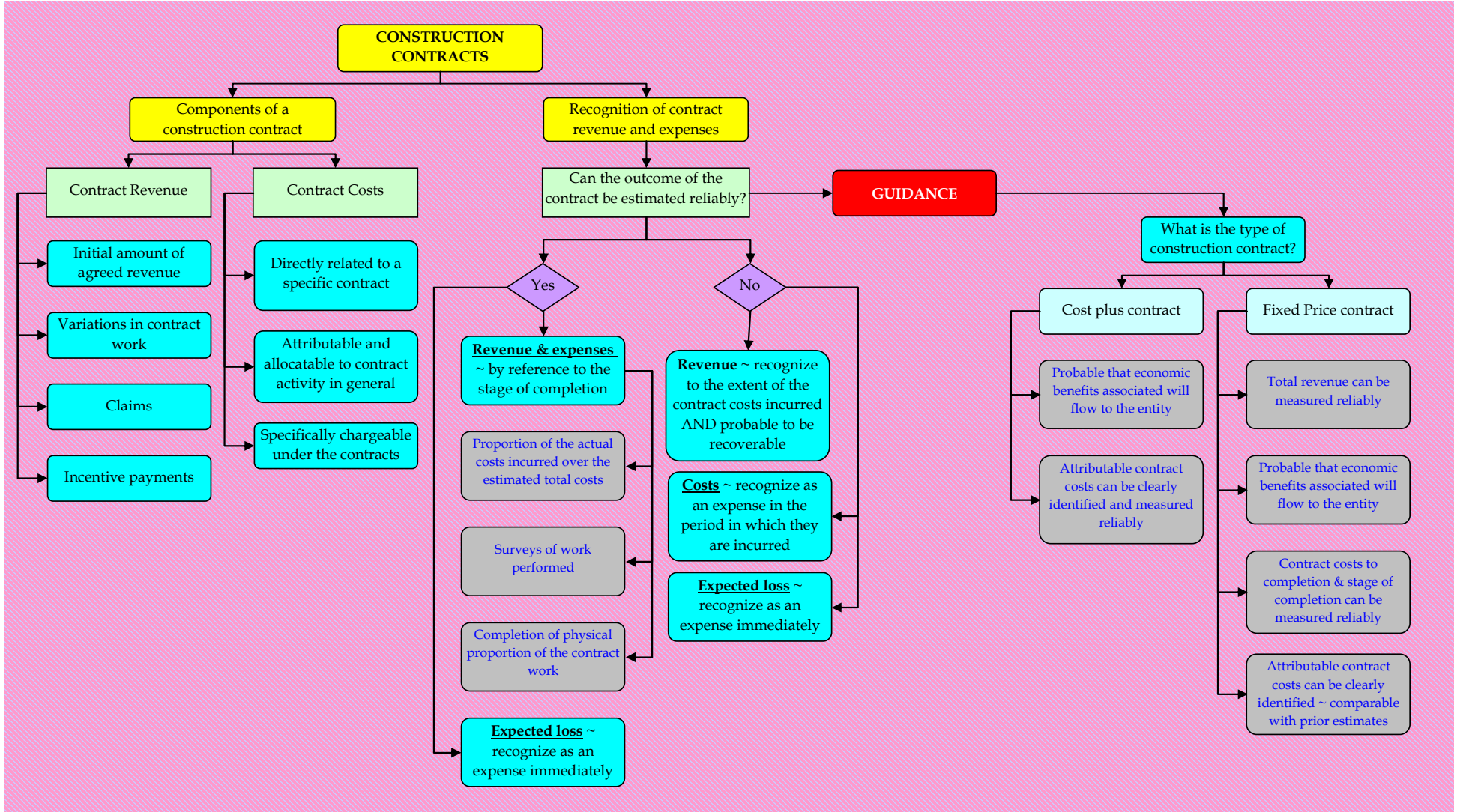
102.36(g) * Inventories written down in prior year have been reversed during the financial year as the management has successfully secured a higher sales amount for those slow moving inventories.

107.45 **45. Cash and Cash Equivalents**

		THE GROUP		THE COMPANY	
		2006	2005	2006	2005
		RM'000	RM'000	RM'000	RM'000
	Fixed deposits with licensed banks				
	Cash and bank balances				
	Bank overdrafts				
		<hr/>			
107.48	Less: Fixed deposits pledged				
107.48	Less: Cash at bank held under Housing Development Account				
		<hr/>			
	Cash and cash equivalents as previously reported				
107.28	Effect of foreign exchange rate changes				
		<hr/>			
		<hr/>			

FRS 111₂₀₀₄ Construction Contracts

DIAGRAMMATIC ILLUSTRATION OF FRS 111₂₀₀₄



SAMPLE COMPLIANCE CHECKLIST

REF.	COMPLIANCE CHECKLISTS	EXAMPLE/ SAMPLE DISCLOSURES NOTES
	<p><u>SCOPE</u></p>	
111.1 ~ 2	<p>FRS 111²⁰⁰⁴ shall be applied in accounting for construction contracts in the financial statements of contractors.</p> <p>However, exempt entities need not comply with FRS 111²⁰⁰⁴.</p>	
	<p><u>DEFINITION</u></p>	
111.4 ~ 7	<p><u>Construction contract</u> ~ A contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.</p> <p><i>Construction contracts include:-</i></p> <p>(a) <i>Contracts for the rendering of services which are directly related to the construction of the asset, such as services of project managers and architects.</i></p> <p>(b) <i>Contracts for destruction or restoration of assets, and restoration of the environment following the demolition of assets.</i></p> <p><u>Fixed price contract</u> ~ 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.</p> <p><u>Cost plus contract</u> ~ A construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.</p> <p><i>For construction contracts which contain characteristics of both a fixed price contract and a cost plus contract (such as cost plus contract with an agreed maximum price) → consider all conditions in FRS 111.24 and 25 to determine the timing of recognition of contract revenue and expenses.</i></p>	
	<p><u>COMBINING AND SEGMENTING CONSTRUCTION CONTRACTS</u></p>	
111.9	<p>When a contract covers a number of assets → treated as a <u>separate construction contract</u> when:</p> <p>(a) Separate proposals have been submitted;</p> <p>(b) Each asset has been subject to separate negotiation and the parties have been able to accept or reject that part of the contract relating to each asset; and</p> <p>(c) Costs and revenues of each asset can be identified.</p>	
111.10	<p>A group of contracts (with a single or several customers) → treated as a <u>single</u></p>	

	<p>construction contract when:</p> <ul style="list-style-type: none"> (a) Negotiated as a single package; (b) Contracts are so closely interrelated that they are part of a single project with an overall profit margin; and (c) Performed concurrently or in a continuous sequence. 	
111.11	<p>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.</p> <p>Construction of the additional asset → treated as a separate construction contract when:</p> <ul style="list-style-type: none"> (a) Asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or (b) The price of the asset is negotiated without regard to the original contract price. 	
111.12 ~ 16	<p>CONTRACT REVENUE</p> <p>Contract revenue shall comprise:</p> <ul style="list-style-type: none"> (a) Initial amount of revenue agreed; and (b) Variations in contract work, claims and incentive payments: <ul style="list-style-type: none"> (i) To the extent that it is probable that they will result in revenue; and (ii) They are capable of being reliably measured. 	<p>Contract Revenue</p> <ul style="list-style-type: none"> → Measured at the fair value of the consideration received or receivable. → Measurement is affected by a variety of uncertainties that depend on the outcome of future events → often need to be revised as events occur and uncertainties are resolved. <p>Variation</p> <ul style="list-style-type: none"> → Instruction by the customer for a change in the scope of the work to be performed under the contract. → Lead to an increase or a decrease in contract revenue. <p>Claim</p> <ul style="list-style-type: none"> → An amount that the contractor seeks to collect from the customer or another party as reimbursement for costs NOT included in the contract price. → May arise from customer caused delays, errors in specifications or design, and disputed variations in contract work. → Subject to a high level of uncertainty and often depends on the outcome of negotiations. <p>Incentive payments</p> <ul style="list-style-type: none"> → Additional amounts paid to the contractor if specified performance standards are met or exceeded, e.g., early completion of the contract.

<u>CONTRACT COSTS</u>	
111.17 ~ 22	<p>Contract costs shall comprise:</p> <p>(a) Costs that relate directly to the specific contract;</p> <p>(b) Costs that are attributable to contract activity in general <u>and</u> can be allocated to the contract; and</p> <p>(c) Other costs specifically chargeable to the customer under the terms of the contract.</p>
	<p><u>Costs that relate directly to a specific contract</u></p> <p><i>Example:</i></p> <ul style="list-style-type: none"> → Site labour costs; → Costs of materials used in construction; → Depreciation of plant and equipment used; → Costs of moving plant, equipment and materials to and from the construction site; → Costs of hiring plant and equipment; → Costs of design and technical assistance that is directly related; → Estimated costs of rectification and guarantee work, including expected warranty costs; and → Claims from third parties. <p><i>These costs may be reduced by any incidental income that is <u>NOT</u> included in contract revenue.</i></p> <p><u>Costs that may be attributable to contract activity in general and can be allocated to specific contracts</u></p> <p><i>Example:</i></p> <ul style="list-style-type: none"> → Insurance; → Costs of design and technical assistance that are NOT directly related to a specific contract; and → Construction overheads. <p><i>Basis for the allocation of these expenses:-</i></p> <ul style="list-style-type: none"> ✓ Using methods that are systematic and rational; ✓ Applied consistently to all costs having similar characteristics. ✓ Based on normal level of construction activity. ✓ May also include borrowing costs when the contractor adopts allowed alternative treatment in FRS 123₂₀₀₄ Borrowing Costs. <p><u>Costs that are specifically chargeable to the customer under the contracts</u></p> <p><i>Example:</i></p> <ul style="list-style-type: none"> → Reimbursement of general administration costs and development costs specified in the terms of the contract. <p><u>Costs that CANNOT be attributed to contract activity or CANNOT be allocated to a contract are EXCLUDED from the costs of a construction contract</u></p>

		<p>Example:</p> <ul style="list-style-type: none"> → General administration costs: reimbursement not specified in the contract; → Selling costs; → Research and development costs for which reimbursement is not specified in the contract; and → Depreciation of idle plant and equipment that is not used on a particular contract. <p>Contract costs:</p> <ul style="list-style-type: none"> → INCLUDE costs attributable to a contract for the period <u>from</u> the date of securing the contract <u>to</u> the final completion of the contract. → INCLUDE costs that relate directly to a contract and which are incurred in securing the contract → if they can be separately identified and measured reliably and it is probable that the contract will be obtained. → EXCLUDE in contract costs → when costs incurred in securing a contract are recognized as an expense in the period in which they are incurred, BUT contract is obtained in a subsequent period.
<p><u>RECOGNITION OF CONTRACT REVENUE AND EXPENSES</u></p>		
<p>111.23, 26 ~ 32</p>	<p>Outcome of a construction contract can be estimated reliably → Contract revenue and contract costs associated with the construction contract → recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date.</p> <p>Expected loss on the construction contract → recognized as an expense immediately in accordance with FRS 111.37.</p>	<p>Percentage of Completion Method</p> <ul style="list-style-type: none"> → Contract revenue is matched with the contract costs incurred in reaching the stage of completion → revenue, expenses and profit which can be attributable to the proportion of work completed. → Contract revenue → recognized in the income statement in the periods in which the work is performed. → Contract costs → usually recognized as an expense in the income statement in the periods in which the work to which they relate is performed. → Expected excess of total contract costs over total contract revenue → recognized as an expense immediately in accordance with FRS 111.37. → Contract costs that relate to future activity on the contract → recognized as an asset provided it is PROBABLE that they will be recovered ~ represent an amount due from the customer. → Uncertainty on the collectibility of an amount already recognized in income statement → the amount should be recognized as an expense rather than as an adjustment of the contract revenue. <p>Criteria to make reliable estimates after an entity has agreed to a contract which establishes:</p> <p>(a) Each party's enforceable rights regarding the asset to be constructed;</p>

		<p>(b) Consideration to be exchanged; and (c) Manner and terms of settlement.</p> <p>Ways to determine the stage of completion Depending on the nature of the contract, the methods may include:</p> <p>(a) Proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;</p> <ul style="list-style-type: none"> ✓ ONLY those contract costs that reflect work performed are <u>included</u> in costs incurred to date; ✓ Contract costs on future activity are <u>excluded</u>, for example materials delivered but not yet used during the contract performance, UNLESS the materials have been made specifically for the contract; and ✓ Payments made to subcontractors in advance of work performed are <u>excluded</u>. <p>(b) Surveys of work performed; or (c) Completion of a physical proportion of the contract work.</p> <p>Note: Progress payments and advances received from customers often do not reflect the work performed.</p>
111.24	<p><u>FIXED PRICE CONTRACT</u> Outcome of a construction contract can be estimated reliably when <u>ALL</u> the following conditions are satisfied:</p> <p>(a) Total contract revenue can be <i>measured reliably</i>;</p> <p>(b) <i>Probable</i> that economic benefits associated with the contract <i>will flow to the entity</i>;</p> <p>(c) <u>BOTH</u> the contract costs to complete the contract <u>AND</u> the stage of contract completion at the balance sheet date can be <i>measured reliably</i>; and</p> <p>(d) Contract costs attributable to the contract can be <i>clearly identified</i> and <i>measured reliably</i> → actual contract costs incurred can be compared with prior estimates.</p>	
111.25	<p><u>COST PLUS CONTRACT</u> Outcome of a construction contract can be estimated reliably when <u>ALL</u> the following conditions are satisfied:</p> <p>(a) <i>Probable</i> that economic benefits associated with the contract <i>will flow to the entity</i>;</p> <p>(b) Contract costs attributable to the contract (whether or not specifically reimbursable) can be <i>clearly identified</i> and <i>measured reliably</i>.</p>	
111.33 ~ 34	<p>When the outcome of a construction contract <u>CANNOT</u> be estimated reliably:</p> <p>(a) Revenue → recognized ONLY to the extent of contract costs incurred that it is <u>PROBABLE</u> will be recoverable; and</p> <p>(b) Contract costs → recognized as an expense in the period in which they are</p>	<p>Example of circumstances in which the recoverability of contract costs incurred may NOT be probable and in which contract costs may need to be recognized as an expense immediately include contracts:-</p> <p>(a) are not fully enforceable, that is, their validity is seriously in question;</p>

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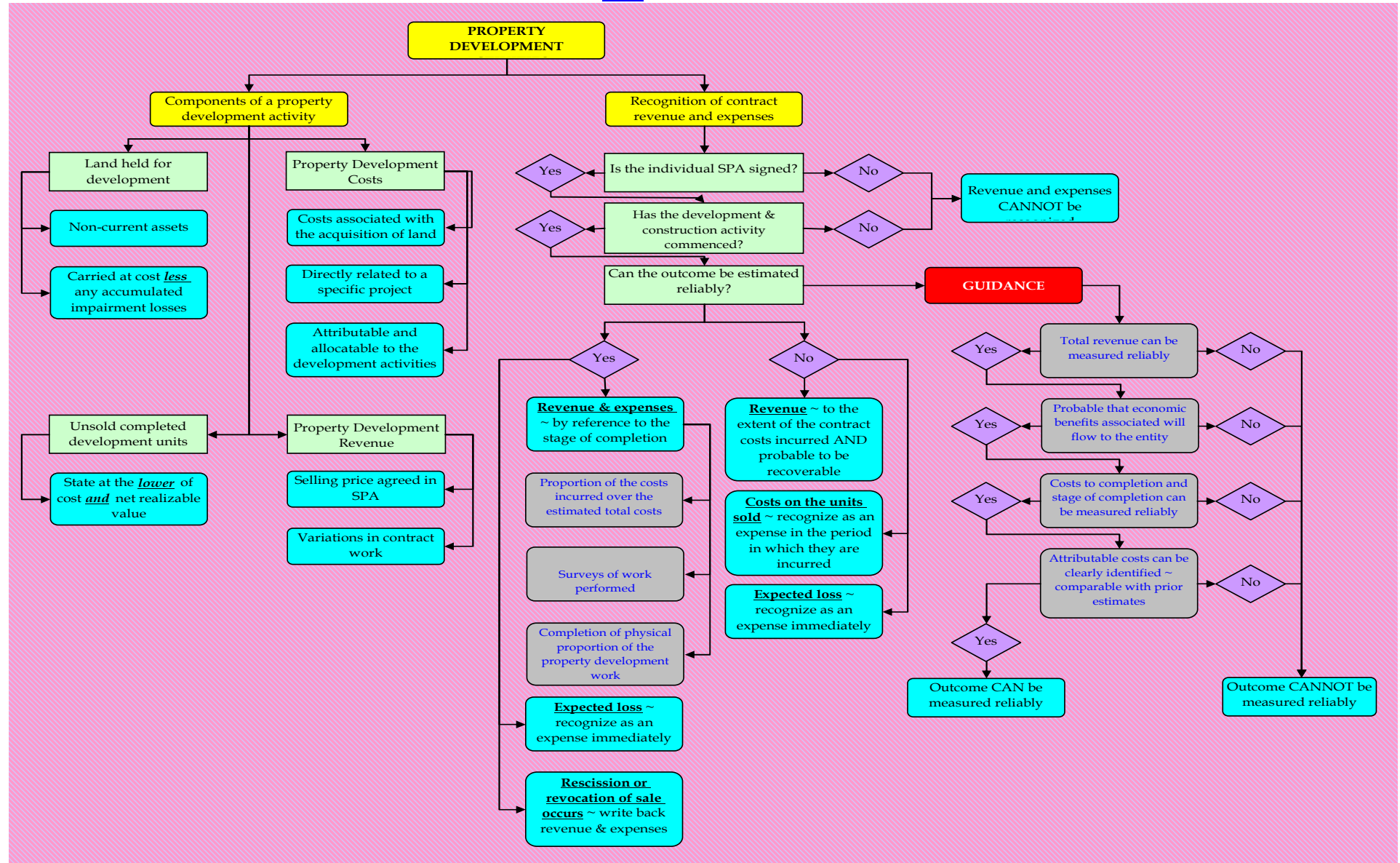
	<p>incurred.</p> <p>(c) Expected loss → recognized as an expense immediately in accordance with FRS 111.37.</p> <p>Thus, NO profit is recognized if the outcome of the contract cannot be estimated reliably.</p>	<p>(b) <i>the completion of which is subject to the outcome of pending litigation or legislation;</i></p> <p>(c) <i>relating to properties that are likely to be condemned or expropriated;</i></p> <p>(d) <i>where the customer is unable to meet its obligations; or</i></p> <p>(e) <i>where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.</i></p>
111.36	<p>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 recognized in accordance with FRS 111.23 rather than FRS 111.33.</p>	
	<u>RECOGNITION OF EXPECTED LOSSES</u>	
111.37 ~ 38	<p>When it is probable that total contract costs will exceed total contract revenue → expected loss shall be recognized as an expense immediately.</p> <p>The amount is determined irrespective of:</p> <p>(a) whether or not work has commenced on the contract;</p> <p>(b) stage of completion of contract activity; or</p> <p>(c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with FRS 111.10.</p>	
	<u>CHANGE IN ESTIMATES</u>	
111.39	<p>Percentage of completion method:-</p> <ul style="list-style-type: none"> ✓ Applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. ✓ Effect of a change in the estimate of contract revenue or contract costs, or the outcome of a contract, is accounted for as a change in accounting estimate. ✓ Changed estimates are used in the determination of the amount of revenue and expenses recognized in the income statement in the period in which the change is made and in subsequent periods. 	
	<u>DISCLOSURE</u>	
111.40	<p>To disclose:</p> <p>(a) Amount of contract revenue recognized as revenue in the period;</p> <p>(b) Amount of contract costs recognized as an expense in the period;</p> <p>(c) Methods used to determine the contract revenue recognized in the period; and</p> <p>(d) Methods used to determine the stage of completion of contracts in progress.</p>	

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111.41	<p>For contracts in progress at the balance sheet date, to disclose:</p> <ul style="list-style-type: none"> (a) Aggregate amount of costs incurred and recognized profits (less recognized losses) to date; (b) Amount of advances received; and (c) Amount of retentions. 		
111.43	<table border="0" style="width: 100%;"> <tr> <td style="width: 50%; vertical-align: top;"> <p>To present:</p> <ul style="list-style-type: none"> (a) Gross amount due from customers for contract work as an asset; and (b) Gross amount due to customers for contract works as a liability. </td> <td style="width: 50%; vertical-align: top;"> <p><u>Gross Amount Due From Customers</u> Net amount of: (a) Costs incurred PLUS recognized profits; less (b) Sum of recognized losses and progress billings for all contracts in progress for which (a) > (b).</p> <p><u>Gross Amount Due To Customers</u> Net amount of: (c) Costs incurred PLUS recognized profits; less (d) Sum of recognized losses and progress billings for all contracts in progress for which (b) > (a).</p> </td> </tr> </table>	<p>To present:</p> <ul style="list-style-type: none"> (a) Gross amount due from customers for contract work as an asset; and (b) Gross amount due to customers for contract works as a liability. 	<p><u>Gross Amount Due From Customers</u> Net amount of: (a) Costs incurred PLUS recognized profits; less (b) Sum of recognized losses and progress billings for all contracts in progress for which (a) > (b).</p> <p><u>Gross Amount Due To Customers</u> Net amount of: (c) Costs incurred PLUS recognized profits; less (d) Sum of recognized losses and progress billings for all contracts in progress for which (b) > (a).</p>
<p>To present:</p> <ul style="list-style-type: none"> (a) Gross amount due from customers for contract work as an asset; and (b) Gross amount due to customers for contract works as a liability. 	<p><u>Gross Amount Due From Customers</u> Net amount of: (a) Costs incurred PLUS recognized profits; less (b) Sum of recognized losses and progress billings for all contracts in progress for which (a) > (b).</p> <p><u>Gross Amount Due To Customers</u> Net amount of: (c) Costs incurred PLUS recognized profits; less (d) Sum of recognized losses and progress billings for all contracts in progress for which (b) > (a).</p>		
111.46	<p>Disclose any contingent liabilities and contingent assets in accordance with FRS 137₂₀₀₄ ~ may arise from such items as warranty costs, claims, penalties or possible losses.</p>		
<p><u>EFFECTIVE DATE</u></p>			
111.48	<p>FRS 111₂₀₀₄ becomes operative for financial statements covering periods beginning on or after 1 July 1999.</p>		

FRS 201₂₀₀₄ Property Development Activities

DIAGRAMMATIC ILLUSTRATION OF FRS 201₂₀₀₄



SAMPLE COMPLIANCE CHECKLISTS

REF.	COMPLIANCE CHECKLISTS	EXAMPLE/ SAMPLE DISCLOSURES NOTES
	<u>SCOPE</u>	
201.1, 4	FRS 201 ²⁰⁰⁴ shall be applied in accounting for property development activities in the financial statements of an entity undertaking property development activities.	<p><u>Property development</u> Business of acquiring land for purposes of:</p> <ul style="list-style-type: none"> (a) Construction thereon and selling completed residential, and/or commercial and industrial buildings whether as a whole or by parcels therein; and (b) Development and sale of vacant lots for the construction of such buildings thereon including homesteads, hobby farms, orchards or for other similar purposes
	<u>DEFINITION</u>	
201.5	<p><u>Project</u> ~ a cluster of development units erected within a designated geographical area forming a cost accumulating centre.</p> <p><u>Property development activities</u> ~ activities involving the necessary steps to plan and construct, and comply with statutory and contractual requirements in the development of land into vacant lots, residential, commercial and/or industrial buildings.</p> <p><u>Development unit</u> ~ a unit of residential, commercial or industrial building, and vacant lot developed for sale.</p> <p><u>Relative sales value</u> ~ ratio of the estimated current selling price of each individual development unit at the time the evaluation is being carried out, in the final state that it is intended to be sold to that of others to be developed in the development project.</p>	
	<u>LAND HELD FOR PROPERTY DEVELOPMENT</u>	
201.11 ~ 14	<p><u>Classification of land held for development</u> Classified as non-current asset where:-</p> <ul style="list-style-type: none"> ✓ no development activities have been carried out; or ✓ development activities are not expected to be completed within the normal operating cycle. <p><u>Carrying amount of land held for development</u> Carried at:-</p> <ul style="list-style-type: none"> ✓ cost less any accumulated impairment losses. 	<p><u>Changes in the classification of land held for development</u> Change to current asset shall be at the point when:-</p> <ul style="list-style-type: none"> ✓ development activities have commenced; and ✓ where it can be demonstrated that the development activities can be completed within the normal operating cycle.

	✓ apply FRS 136 to determine whether the land has become impaired.
	<u>PROPERTY DEVELOPMENT COSTS</u>
201.15	Property development costs shall comprise all costs that:- ✓ are directly attributable to development activities; or ✓ can be allocated on a reasonable basis to such activities.
201.16 ~ 23	<p>Costs relating to property development activities can be divided into:</p> <p>(a) costs associated with the acquisition of land;</p> <p>(b) costs related directly to a specific property development activity; and</p> <p>(c) costs attributable to the development activities in general and can be allocated to the project.</p> <p><u>Acquisition of land</u> <i>Costs associated with the acquisition of land include:</i></p> <ul style="list-style-type: none"> → purchase price of the land; → professional fees; → stamp duties; → commissions; → conversion fees; and → other relevant levies. <p><i>Pre-acquisition costs → charged to income statement as incurred UNLESS such costs are directly identifiable to the consequent property development activity → capitalized and included as property development costs.</i></p> <p><u>Costs allowed to be capitalized</u> All related costs incurred subsequent to the acquisition of land can be capitalized ONLY during periods in which activities necessary to prepare the property for its intended use are in progress. <i>Example:-</i></p> <ul style="list-style-type: none"> → <i>Administrative and technical nature undertaken during the pre-construction stage, such as the preparation of plans and the process of obtaining approvals and permits from government authorities.</i> <p><u>Common costs that may be allocated to property development activities</u> Costs that would be allocated to:-</p> <ul style="list-style-type: none"> → Existing and future property development projects within the same geographical location (related), <i>such as infrastructure costs, mandatory land reserve for educational and recreational purposes;</i> and → All projects currently in progress in various locations (unrelated), <i>for example, certain corporate expenditure that relates to existing property development projects undertaken.</i> <p>Common costs may be allocated using:-</p> <ul style="list-style-type: none"> → relative sales value of the projects that benefited or are going to benefit from such costs, or

		<p>→ other generally accepted methods. Method selected must be applied consistently.</p> <p>Other considerations</p> <ul style="list-style-type: none"> → Include contingency costs such as those relating to defect liability (FRS 137₂₀₀₄). → Costs associated with borrowings on property development projects → accounted for in accordance with FRS 123₂₀₀₄.
201.24	<p>Allocation of costs to individual development units shall be made in accordance with the following criteria:</p> <ul style="list-style-type: none"> (a) Specific identification (eg direct building costs); (b) Relative sales values where specific identification is not possible; or (c) Other appropriate methods consistently applied where allocation based on relative sales value is impracticable. 	
<u>PROPERTY DEVELOPMENT REVENUE AND EXPENSES</u>		
201.25 ~ 26	<p>Property development revenue shall comprise:</p> <ul style="list-style-type: none"> (a) Selling price agreed in the sale and purchase agreements; and (b) Any additional revenue due to variation in development work. 	<p>Variation</p> <ul style="list-style-type: none"> ✓ An instruction by the customer for a change in the scope of the work to be performed under the development project contract. ✓ May lead to an increase or a decrease in development project contract revenue. ✓ Included in project revenue when the amount of revenue can be reliably measured.
201.27 ~ 31	<p>Property development revenue → recognized in respect of all development units that have been sold.</p> <p>Revenue recognition commences when ALL the following criteria are met:</p> <ul style="list-style-type: none"> (a) When the sale of the development unit is effected (upon signing of SPA); (b) Upon the commencement of development and construction activities; and (c) When the financial outcome can be reliably estimated, i.e., when ALL the following conditions are met: <ul style="list-style-type: none"> (i) Total revenue from the development activities can be measured reliably; (ii) Probable that the economic benefits associated with the development project will flow to the entity; (iii) BOTH the costs to complete AND the stage of completion at the balance sheet date can be measured reliably; and (iv) Costs attributable can be clearly identified and measured reliably so that actual development costs incurred can be compared with prior estimates. 	

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	<p>When the outcome of a development activity CANNOT be reliably estimated:</p> <ul style="list-style-type: none"> (a) Property development revenue → recognized ONLY to the extent of property development costs incurred that is PROBABLE will be recoverable; and (b) Property development costs → recognized as an expense in the period in which they are incurred. (c) Expected loss on a development project → recognized as an expense immediately (including costs to be incurred over the defects liability period). <p>Thus, NO profit is recognized if the outcome of the property development project cannot be estimated reliably.</p>
201.32	<p>When property development unit are sold → <i>attributable portion of property development costs</i> shall be recognized as an expense in the period in which the related revenue is recognized.</p>
201.34 ~ 37	<p>Property development revenues and expenses:</p> <ul style="list-style-type: none"> ✓ Recognized in the income statement when the outcome of a development activity can be estimated reliably. ✓ Amount shall be determined by reference to the stage of completion of development activity at the balance sheet date. <p style="text-align: right;">Percentage of Completion Method</p> <p style="text-align: right;">→ Property development revenue is matched with the property development expenses incurred in reaching the stage of completion → <i>revenue, expenses and profit which can be attributable to the proportion of work completed.</i></p> <p style="text-align: right;">Ways to determine the stage of completion</p> <p style="text-align: right;">Depending on the nature of the development activity, the methods may include:</p> <ul style="list-style-type: none"> (a) Proportion that property development costs incurred for work performed to date bear to the estimated total property development costs; <ul style="list-style-type: none"> ✓ <i>ONLY those property development costs that reflect work performed are included in costs incurred to date.</i> ✓ <i>Examples of costs that do NOT relate to work performed are costs of land, financing costs capitalized to the project, and payments made to contractors in advance of work performed under the project.</i> (b) Surveys of work performed; or (c) Completion of a physical proportion of the property development work. <p style="text-align: right;">Note: Progress billings to purchases and payments received often do not reflect the work performed.</p>
201.38	<p>When the uncertainties that prevented the outcome of the project being estimated reliably no longer exist → revenue and expenses associated with the development activity shall be recognized in accordance with FRS 111.34</p>

201.39	Property development costs NOT recognized as an expense → recognized as an asset AND shall be measured at the lower of cost and net realizable value.	
<u>ESTIMATES, REVOCATION OF SALES AND INCENTIVES</u>		
201.40 ~ 41	<p>Estimates and cost allocations → reviewed at the end of each financial reporting period until the project is substantially completed.</p> <p>Costs shall be revised and reallocated where necessary for any changes on the basis of current estimates.</p> <p>Effects of a change in an accounting estimate → included in the determination of profit or loss in accordance with FRS 108.</p>	
201.43	Project development revenue and expenses recognized → immediately written back as soon as a rescission or revocation of sale occurs.	
201.44 ~ 47	<p>Liquidated damages receivable from contractors (on late completion); and Liquidated damages payable to purchasers (for late delivery) → Disclosed as gross amounts in the income statement.</p>	<p>Sales incentives, other guarantees</p> <ul style="list-style-type: none"> ✓ Estimated obligation → accounted for according to FRS 137²⁰⁰⁴. ✓ Other incentives or promotional costs incurred that are associated with the sale of its development units → shall NOT be capitalized BUT are to be recognized in the income statement. <p>Other examples that are to be taken to the income statement:</p> <ul style="list-style-type: none"> ✓ Administrative and maintenance fees; ✓ Forfeited deposits; and ✓ Interest receivables.
<u>INVENTORIES - UNSOLD COMPLETED DEVELOPMENT UNITS</u>		
201.48 ~ 49	Inventories of unsold completed development units → stated at the LOWER of cost AND net realizable value.	Unsold completed development units retained by an entity → accounted for in accordance with FRS 116 or FRS 140.
<u>DISCLOSURE</u>		
201.50	To disclose: (a) Method used to determine the stage of completion for property development activities; (b) Revenue and related expenses recognized in the income statement; (c) In respect of property development costs carried as an asset, a reconciliation of	

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	<p>the carrying amount at the beginning and end of the period showing:</p> <ul style="list-style-type: none"> (i) Gross amounts of property development costs, segregating the portion related to land; (ii) Property development costs incurred during the period; (iii) Amount of property development costs recognized as an expense in the income statement. Showing brought forward and current period amounts; and (iv) Disposals or transfers to other category of assets or any other changes in the carrying amount during the period. <p>(d) In respect of progress billings:</p> <ul style="list-style-type: none"> (i) Accrued billings as current asset, representing the excess of revenue recognized in the income statement over the billings to purchasers; and (ii) Progress billings as current liability, representing the excess of billings to purchasers over revenue recognized in the income statement; and <p>(e) Amount of cash held under Housing Development Account [opened and maintained under section 7A of the Housing Development (Control and Licensing) Act 1966] and any other restrictions on cash.</p>
201.51	<p>For land held for property development, to disclose:</p> <ul style="list-style-type: none"> (a) Gross carrying amount of the cost and accumulated impairment loss (if any) at the beginning and end of the period; and (b) A reconciliation of the carrying amount at the beginning and end of the period showing: <ul style="list-style-type: none"> (i) Additions; (ii) Disposals; (iii) Transfers to current assets as property development costs; (iv) Impairment losses recognized / reversed in the income statement during the period, if any; and (v) Other movement.
201.52	<p>Also to disclosed:</p> <ul style="list-style-type: none"> (a) Existence and amounts of restrictions of titles of land; and (b) Land held for property development and property development projects pledged as security for liabilities.
	<p><u>TRANSITIONAL PROVISIONS</u></p>
201.53	<p>Adoption of the provisions of FRS 201₂₀₀₄ results in a change in accounting policy → apply retrospectively in accordance with FRS 108.</p>
201.54	<p>Where an entity has carried its land held for property development at revalued</p>

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	amount as allowed under MASB Approved Accounting Standard MAS 7 → continue to retain the revalued amount of the land (and subsequently, its carrying costs) as its surrogate cost.
	<u>EFFECTIVE DATE</u>
201.55	FRS 201 ₂₀₀₄ becomes operative for annual financial statement covering periods beginning on or after 1 January 2004.



AXP TECHNICAL DIAGNOSTIC CENTRE

Question One ~ Financial Reporting by A Foreign Branch



Background and Issues

A public practitioner has an audit client which is registered with the Companies Commission of Malaysia (CCM) as a branch of a foreign company. In performing the audit of the said branch, the practitioner wishes to find out whether there are any differences in the formats of the audited financial statements of the branch of a foreign company in comparison with a local private company.



References

Our proposed solutions are made with reference to:-

1. Companies Act, 1965 (CA); and
2. Relevant Financial Reporting Standards (FRS) and Private Entity Reporting Standards (PERS).



Our Proposed Solutions

Legal Obligation

In accordance with Section 336A of the CA, every foreign company shall keep accounting and other records in Malaysia which will sufficiently explain the transactions and financial position of that foreign company for transactions arising out of the operations in Malaysia.

The accounting and other records shall be kept in such a manner as to enable them to be conveniently and properly audited. These financial statements are required to be audited under Section 336(6) of the CA by an approved company auditor defined in Section 8 of the CA.

The following are the components of the audited financial statements required to be prepared by the foreign company:-

<i>Sections</i>	<i>Notes</i>
<i>Directors' Report</i>	Directors' report, required under Section 169 of the CA, is <u>not</u> required to be presented by a foreign company.
<i>Statement by directors</i>	Statement by directors, required under Section 169 (15) of the CA, is <u>not</u> required to be presented by a foreign company.
<i>Statutory declaration</i>	<p>As required under Section 336 (6) of the CA, statutory declaration should be made by the "agent"[☐] of the foreign company in Malaysia.</p> <p>Where the agent is not primarily responsible for the financial management of the company, statutory declaration should be made by the person responsible setting forth his opinion as to the correctness or otherwise of the financial statements.</p> <p>The format of the statutory declaration is similar to the statutory declaration to be included by the local company, except for the word "director" should be replaced with "agent".</p>
<i>Auditors' report</i>	<p>Auditors' report is also required under Section 336(6) of the CA and should be complied with Section 174 of the CA.</p> <p>Please refer to the end of this question for the sample of an unqualified auditors' report.</p>
<i>Financial statements and the notes to the financial statements</i>	Depending on the legal and financial reporting requirements of the Headquarters, the financial statements of the foreign

[☐] Agent of a foreign company is the person named in a memorandum of appointment or power of attorney under the seal of the of the foreign company lodged under Section 332 (1)(e), 333(b) or under any corresponding previous written law.

company's operations in Malaysia shall be prepared in compliance with either FRS or the PERS.

Minimum alteration may be required such as changing "Company" to "Company's operations in Malaysia", there is no share capital for the branch of a foreign company, etc.

Financial Reporting Considerations

As indicated earlier, the financial statements of the foreign company's operations in Malaysia may be prepared in accordance with either FRS or PERS.

However, we wish to specifically highlight the selection of currency as the functional and presentation currency as defined in **FRS 121 The Effect of Changes in Foreign Exchange Rates:-**

- ✓ The foreign company is required to assess the functional currency to be used based on the primary economic environment in which it operations, for instance, it may be using the headquarters' currency.
- ✓ However, for financial statements presented in Malaysia, the presentation currency shall be in Ringgit Malaysia. In this circumstance, even though the foreign company is using, says, Hong Kong Dollar as its functional currency, it is required to prepare its financial statements in Ringgit Malaysia for submission to CCM and its headquarters. (*Note: this requirement is different from the requirements of IAS 21, in which the presentation currency can be denominated in any currency.*)

For more information on how to convert the transactions denominated in functional currency to presentation currency, please refer to **AXP Technical e-Newsletter - January 2006 Issue**.

Sample ~ Unqualified Auditors' Report on foreign company's operations in Malaysia

**Report of the Auditors on the Company's operations in Malaysia
Pursuant to Section 336 of the Companies Act 1965
ABC LIMITED**

(Incorporated in Hong Kong Special Administrative Region)

We have audited the accompanying balance sheet as at ___ and the related statements of income, cash flows and changes in equity for the year ended on that date.

These financial statements are the responsibility of the agent(s). It is our responsibility to form an independent opinion, based on our audit, on these financial statements and to report our opinion to you, as a body, in accordance with Section 174 of the Companies Act 1965 and for no other purpose. We do not assume responsibility towards any other person for the content of this report.

We conducted our audit in accordance with approved standards on auditing in Malaysia. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the agent(s), as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion:

- (a) the financial statements are properly drawn up in accordance with the provisions of the Companies Act 1965 and the applicable approved accounting standards in Malaysia so as to give a true and fair view of the state of affairs of the Company's operations in Malaysia as at ___ and of the results and the cash flows of the Company's operations in Malaysia for the year then ended; and
- (b) the accounting and other records and the registers required by the Act to be kept by the Company's operations in Malaysia have been properly kept in accordance with the provisions of the Act.

Question Two ~ Treatment of Rental Income Derived From Unsold Completed Development Units of A Property Developer



Background and Issues

A public listed property development company has some unsold completed development units. In order for them to generate income from these inventories, the Management has decided to rent out these properties for a short period of approximately 6 months.

Issues raised are:-

1. Should they recognize these completed properties as “investment properties” in accordance with FRS 140 Investment Properties or remain as inventories (unsold completed development unit)?
2. How should they present their income from the rental of these completed properties?
3. What are the potential tax consequences for this arrangement?



References

References are made to the following sources:-

1. IRB’s Public Ruling; and
2. FRS 140 Investment Properties.



Our Proposed Solutions

Recognition of Unsold Completed Development Units Rented Out For A Short Period

These unsold completed development units, which were rented out for a short period, are not held with the view to earn rental or for capital appreciation, rather, these properties will be sold in the ordinary course of business in near future.

Hence, based on the recognition criteria as specified in FRS 140 Investment Properties, these properties do not meet the recognition criteria as “Investment Properties”. As a result, they

should be continued to be recognized as inventories until the properties are sold, or, until the Management decides to keep these properties with the views to earn rental or for capital appreciation, they shall be recognized as investment properties. They may also opt to keep these properties for their own uses, and the properties should be recognized as property, plant and equipment.

Presentation of Rental Income from Unsold Completed Development Units

From accounting point of view, rental income generated from these unsold completed development units should be presented as “other income” unless the principal activities of the company also include rental of properties.

Tax Position of This Arrangement

From tax’s point of view, rental income generated from these remaining completed development units awaiting for sale is subject to tax under Section 4(a) of the Income Tax Act 1967 (ITA).

Furthermore, Section 24(2) of the ITA is not applicable if the inventories are not transferred to property, plant and equipment or investment properties. When these completed properties are sold subsequently, the profits are subject to income tax under Section 4(a) of the ITA.

When the Management decides to transfer these properties to property, plant and equipment or investment properties, Section 24(2) of the ITA applies. In such cases, the market value of these properties transferred shall be treated as gross income, and profits from this transaction shall be subject to income tax under Section 4(a) of the ITA. Subsequently, if the Company sells these properties, gain on disposal of the properties will be subjected to real properties gain tax.