

Technical e-Newsletter

November 2006 Issue

COMPLIANCE CHECKLISTS & SAMPLE DISCLOSURE NOTES

FRS 123₂₀₀₄ Borrowing Costs
FRS 204₂₀₀₄ Accounting for Aquaculture

TECHNICAL DIAGNOSTIC CENTRE

Can the unutilized re-investment allowance carried forward be recognized as deferred tax assets / deferred assets?

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



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Editors' Notes ~ PERS vs FRS

Greetings!!

Time really waits for no man and flies by in a blink of an eye. It has been a year since we started discussing the possible impact of the FRS "Tsunami" in the financial world and now it has become part and parcel of our lives. The audited results of the public listed companies ("PLC") under the new FRS regime will be announced in just a few months and we wait with interest to find out how the new FRS has affected the bottom line of the PLC. After a slew of changes, we are finally able to enjoy a moment of respite as IASB recently announced the good news that there will not be any significant changes in IFRS until 2009.

For private entities, the financial statements will be simplified following the announcement of the emergence of Private Entity Reporting Standards, a simplified version of the existing MASB Standards, effective for annual financial statements beginning on or after 1 January 2006.

In this issue of the e-Newsletter, we have analyzed two relatively "shorter" financial reporting standards, but they may not necessarily be less complex than the other standards. Firstly, there are many issues to be considered in FRS 123₂₀₀₄ Borrowing Costs, for instance, the timing for the commencement, suspension and cessation of capitalization of borrowing costs. The decision to capitalize or expense off borrowing costs directly attributable to the acquisition, construction, or production of a qualifying asset will have a significant impact on the bottom line and might distort the comparability of the financial statements among companies.

As a result, IASB has proposed to amend IAS 23 Borrowing Costs to eliminate the choice available for the users. Please refer to Technical Diagnostic Centre ("TDC") of July 2006 Issue for more details.

For FRS 204₂₀₀₄ Accounting for Aquaculture, issues that arose concern the valuation of cost of aquaculture inventories, determination and recognition of revenue, recognition of initial investment, costs incurred during the grow-up period, etc.

Aquaculture is a unique industry in Malaysia and there are few players here. There is, notably, a company listed on the Main Board of the Bursa Malaysia which deals in the breeding of ornamental fishes. Based on the Company's latest audited results, the profit before tax margin stood at 45% while gearing ratio was 19%, a pretty profitable and healthy company.

For the TDC, we have studied a policy statement issued by MASB, particularly on whether the unutilized reinvestment allowance carried forward can be recognized as deferred tax assets. We have also examined the issue further using case studies on the accounting policy currently adopted by a PLC, which adopts unutilized reinvestment allowance as "deferred assets".

The Compliance Checklists and the Sample Notes to the Financial Statements illustrated in this 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
November 2006

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SAMPLE NOTES TO THE FINANCIAL STATEMENTS

COMPLYING WITH *FRS 123*₂₀₀₄ AND *204*₂₀₀₄



EXTRACTS OF NOTES TO THE FINANCIAL STATEMENTS:

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

118.36(a) **Revenue**

Sales of goods are recognized when the significant risks and rewards of ownership have been transferred to the buyer. Revenue is measured at the fair value of the consideration received or receivable, net of discounts and taxes applicable to the revenue.

204.38(a) **Income of aquaculture products is determined based on the project approach by matching costs and revenues of each individual production cycle. Revenue is recognized at the point of sale.**

Revenue from rendering of services is measured by reference to the stage of completion of the transaction at the balance sheet date.

Interest income is recognized using the effective interest method, and accrued on a time basis.

Royalty income is recognized on an accrual basis in accordance with the substance of the relevant agreement.

Dividend income is recognized when the shareholder's rights to receive payment is established.

123.29(a) ***Borrowing costs (where allowed alternative is adopted)***

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalized as part of the cost of the asset when the expenditures for the asset and borrowing costs are being incurred, and activities that are necessary to prepare the asset for its intended use or sale are in progress. Capitalization of borrowing costs is suspended during the extended periods in which active development is interrupted and ceased when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

All other borrowing costs are recognized as an expense in the income statement in the year in which they are incurred.

204.38 (b) ***Inventories ~ aquaculture***

Aquaculture inventories are valued at the lower of cost and net realizable value. Aquaculture stocks are stocks of the identifiable cost units and consist of the aggregate costs of materials, direct farm labour and production overheads and other costs incurred in nurturing the species cultured to their saleable condition.

Net realizable value is estimated based on the most reliable evidence available at the time the estimates are made as to what the inventories are expected to realize upon completion of the cycle.

38. Profit before tax

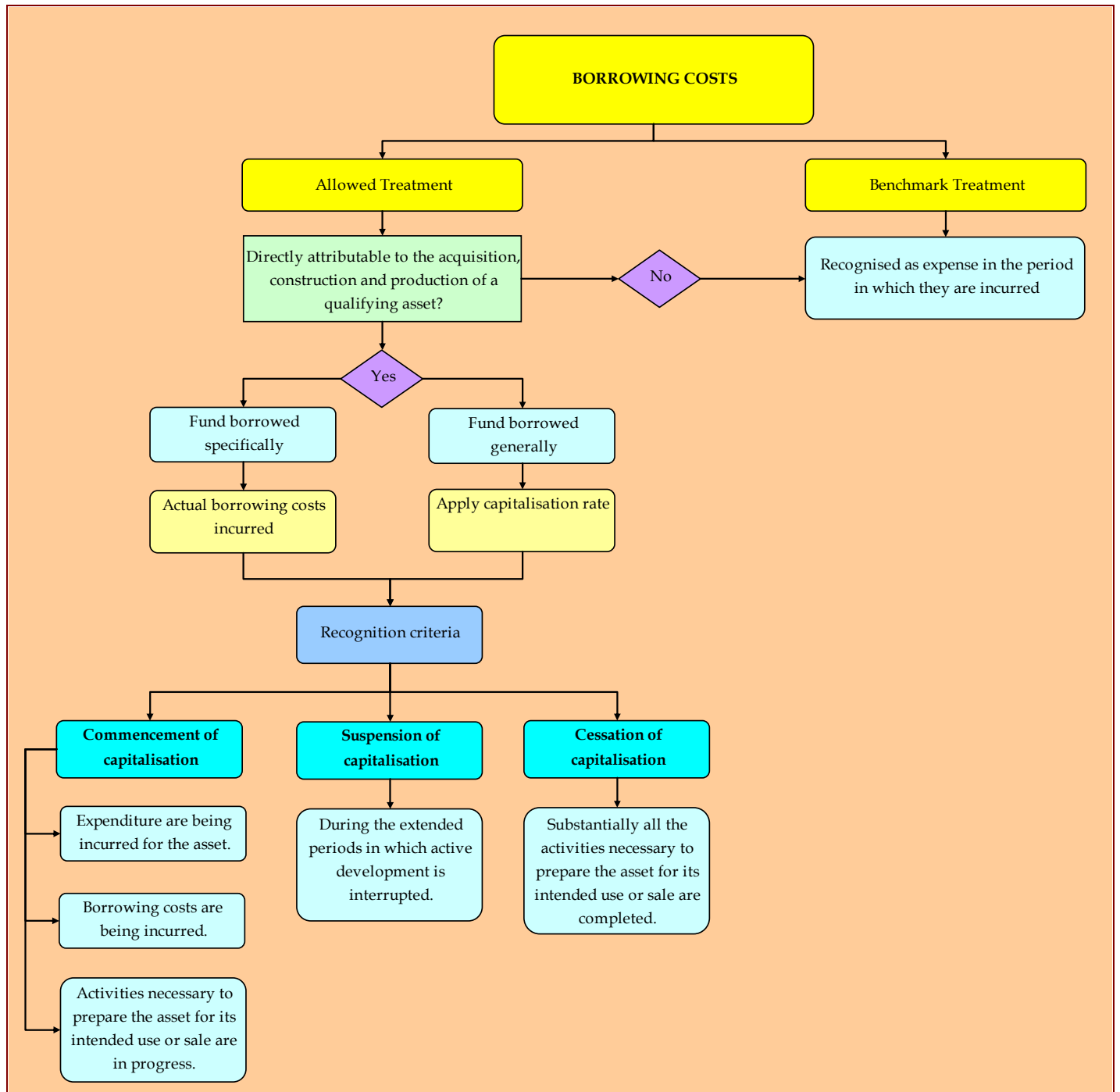
b) Finance costs

	THE GROUP		THE COMPANY	
	2006	2005	2006	2005
	RM'000	RM'000	RM'000	RM'000
Interest expense on:				
Term loans				
Bank overdrafts				
Hire purchase				
Finance lease				
Other short-term bank borrowings				
	<hr/>			
Less interest expenses capitalized under:				
Property, plant and equipment				
Property development costs				
	<hr/>			
Amount charged to income statement				
	<hr/> <hr/>			

Included in finance costs capitalized as part of the cost of qualifying asset is RM___ (2005: RM___) which arose from funds that are borrowed generally. The finance costs capitalized are determined by applying a capitalization rate of ___% (2005: ___%) to the expenditures on that asset.

FRS 123₂₀₀₄ Borrowing Costs

DIAGRAMMATIC ILLUSTRATION OF FRS 123₂₀₀₄



SAMPLE COMPLIANCE CHECKLIST

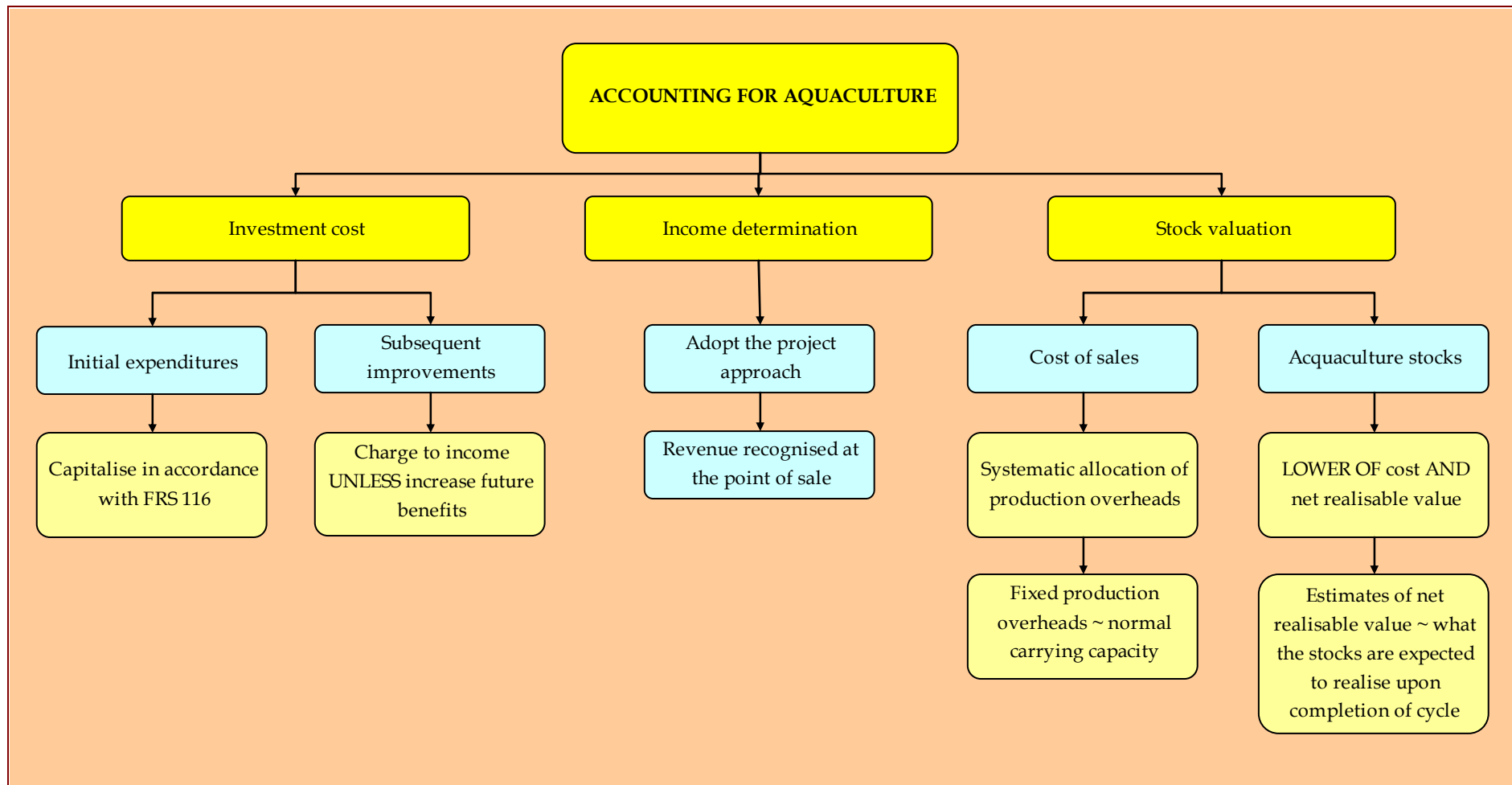
REF.	COMPLIANCE CHECKLISTS	EXAMPLE / SAMPLE DISCLOSURES NOTES
	<u>SCOPE</u>	
123.1 ~ 2	FRS 123 ₂₀₀₄ shall be applied in accounting for borrowing costs.	NOT deal with the actual or imputed cost of equity.
	<u>DEFINITION</u>	
123.3	<p>Qualifying asset - an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.</p> <p>Borrowing costs - interest and other costs incurred by an entity in connection with the borrowing of funds.</p>	
	<u>BORROWING COSTS - BENCHMARK TREATMENT - Recognition</u>	
123.6	Borrowing costs → recognized as an expense in the period in which they are incurred.	
	<u>BORROWING COSTS - BENCHMARK TREATMENT - Disclosure</u>	
123.8	Disclose the accounting policy adopted for borrowing costs.	
	<u>BORROWING COSTS - ALLOWED TREATMENT - Recognition</u>	
123.9	Borrowing costs → recognized as an expense in the period in which they are incurred, <i>except to the extent</i> that they are capitalized in accordance with FRS 123.10.	
123.10	<p>Borrowing costs → capitalized as part of the cost of that asset IF:-</p> <p><i>Directly attributable</i> to the acquisition, construction or production of a qualifying asset.</p> <p>Applied consistently to all borrowing costs that are directly attributable to the acquisition, construction or production of all qualifying assets of the entity.</p> <p>Amount of borrowing costs eligible for capitalization shall be determined in</p>	

	accordance with FRS 123 ₂₀₀₄ .	
	<u>BORROWING COSTS - ALLOWED TREATMENT - Recognition (Borrowing Costs Eligible for Capitalisation)</u>	
123.13		<p>Directly attributable borrowing costs → borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.</p> <p>E.g., borrowing of funds specifically for the purpose of obtaining a particular qualifying asset → borrowing costs directly relate to that qualifying asset and can be readily identified.</p>
123.15	<p>To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset → Amount of borrowing costs eligible for capitalization → actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of that borrowing.</p>	
123.17	<p>To the extent that funds are borrowing generally and used for the purpose of obtaining a qualifying asset → Amount of borrowing costs eligible for capitalization → apply a capitalization rate to the expenditures on that asset.</p> <p>Capitalization rate = weighted average of the borrowing costs applicable to the borrowings that are outstanding during the period (other than borrowings made specifically for the purpose of obtaining a qualifying asset).</p> <p>Amount of borrowing costs capitalized → shall NOT EXCEED the amount of borrowing costs incurred during that period.</p>	
	<u>BORROWING COSTS - ALLOWED TREATMENT - Recognition (Commencement of Capitalization)</u>	
123.20	<p>Capitalization of borrowing costs as part of the costs of a qualifying asset shall commence when:-</p> <ul style="list-style-type: none"> (a) Expenditures for the asset are being incurred; (b) Borrowing costs are being incurred; and (c) Activities that are necessary to prepare the asset for its intended use or sale are in progress. 	

	<u>BORROWING COSTS - ALLOWED TREATMENT - Recognition (Suspension of Capitalization)</u>
123.23	Capitalization of borrowing costs → suspended during the extended periods in which active development is interrupted.
	<u>BORROWING COSTS - ALLOWED TREATMENT - Recognition (Cessation of Capitalization)</u>
123.25	Capitalization of borrowing costs → cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are completed.
123.27	When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts Capitalization of borrowing costs → cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.
	<u>BORROWING COSTS - ALLOWED TREATMENT - Disclosure</u>
123.29	To disclose: (a) Accounting policy adopted for borrowing costs; (b) Amount of borrowing costs capitalized during the period; and (c) Capitalization rate used to determine the amount of borrowing costs eligible for capitalization.
	<u>EFFECTIVE DATE</u>
123.34	This Standard becomes operative for annual financial statements covering periods beginning on or after 1 July 2002.

FRS 204₂₀₀₄ Accounting for Aquaculture

DIAGRAMMATIC ILLUSTRATION OF FRS 204₂₀₀₄



SAMPLE COMPLIANCE CHECKLISTS

REF.	COMPLIANCE CHECKLISTS	EXAMPLE / SAMPLE DISCLOSURES NOTES
204.1 ~ 2	<p><u>INTRODUCTION - General</u></p> <p>Deals with accounting for aquaculture operations where the products from such operations are used mainly for food consumption.</p> <p>It DOES NOT deal with the following specialized aquaculture operations where the products are not intended for food consumption:</p> <ul style="list-style-type: none"> (a) Culture of aquarium fishes and other organism (b) Pearl culture (c) Hatcheries of fry, larvae or fingerlings <p>Applies to entities engaged in aquaculture operations, whether or not, such operations are their main activities.</p>	
204.3	<p><u>INTRODUCTION - Definitions</u></p> <p>Aquaculture – culture and husbandry of desirable aquatic animals and aquatic plants under certain controlled conditions.</p> <p>Carrying capacity – normal capacity that specifies the stocking density of an aquaculture production system.</p> <p>Cost centre – method of income determination measured by matching costs and revenues of individual unit of pond, pen or cage.</p> <p>Identifiable cost unit – unit or centre in which product costs accumulate.</p> <p>Project base – method of income determination measured by matching costs and revenues of each individual product or batch of production cycle.</p>	
204.8	<p><u>ACCOUNTING METHODS - Accounting treatment of initial investment cost</u></p> <p>Initial investment cost = cost of <i>setting up an aquaculture venture</i> → all expenditures whose incurrence are directly attributable and can be allocated on a reasonable basis to bring the venture to its operational condition.</p> <p>Accounting treatment of initial investment cost → <i>capitalized</i> as property, plant and equipment. Carrying amount to be accounted in accordance with FRS 116.</p> <p>Accounting treatment of subsequent improvements → <i>charge to income</i> UNLESS they increase the future benefits from the existing assets beyond their previously assessed standard of performance.</p>	

	<p>Expenditures normally incurred include the following:</p> <ul style="list-style-type: none"> (a) Acquisition cost of land, licenses and rights, (b) Construction cost of farm buildings, premises and other infrastructure, (c) Excavation and construction cost of ponds, pens, cages, canals, roads and gateways, (d) Cost of transportation vehicles, (e) Cost of machinery and equipment.
	<p>ACCOUNTING METHODS - Accounting bases for income determination</p>
204.12 ~ 17	<p>Income Measured on the cost-centre base (Matching costs and revenues of each <u>individual pond, pen or cage</u>)</p> <p>Proponents' argument:</p> <ul style="list-style-type: none"> ✓ Enables costing of the units to approximate those that would prevail in a normal successful operation as costs of the failed units are not spread on to the successful ones. ✓ Prudence → recognizes losses of failed units as the costs incurred are not represented by any or sufficient stocks. <p>Setback</p> <ul style="list-style-type: none"> ✓ Lead to a distortion in the reported periodic results → e.g., losses may be reported for the failed unit in one period while profits may be reported for the successful units in the next period ~ success or failure of each cycle is not determined in totality. ✓ Appears to be in conflict with the matching principle as losses arising from failed units of an uncompleted cycle are matched against revenues of completed cycles. <p>Income Measured on the project base (Matching costs and revenues of each <u>individual project or batch of production cycle</u>)</p> <p>Proponents' argument:</p> <ul style="list-style-type: none"> ✓ Within a production cycle, losses of failed units are a cost of those that are successful. ✓ Each production cycle is distinct and identifiable → accords more closely to the matching of costs and revenues as the result of each cycle is reported in totality. ✓ May overcome some of the difficulties of apportioning fixed production costs across ponds, pens or cages. <p>Setback</p> <ul style="list-style-type: none"> ✓ Costs of the failed units are carried as assets although they are not represented by any or sufficient stocks → appears to be in conflict with the prudence concept. <p>Based on the above arguments → PROJECT BASE generally considered the more satisfactory approach as it tends to reflect fairly the results of farm operations and management.</p>
	<p>ACCOUNTING METHODS - Accounting bases for income determination</p>
204.18 ~ 22	<p>Identification of cost units → based on the principle that the result of each unit is capable of being measured and identified separately.</p> <p>Aquaculture stocks = stocks of the identifiable cost units and consist of the aggregate of costs of material inputs, cost of transformation (<i>direct farm labour and</i></p>

	<p>production overheads) and other costs incurred in nurturing the species cultured to their saleable condition. Production overheads include indirect materials, indirect labour and depreciation, etc.</p> <p>Allocation of fixed production overheads to the costs of stocks → by relating it to the normal carrying capacity of the farm operations. However, the carrying capacity can be partially changed by husbandry practices → normal carrying capacity shall be determined in advance to provide a reasonable basis for allocating fixed production overheads.</p> <p>At a minimum, the following items shall be inventoried to aquaculture stocks:</p> <ol style="list-style-type: none"> Variable material costs. Direct farm labour. Direct fixed costs. A reasonable allocation of indirect fixed costs.
	<p>ACCOUNTING METHODS - Stock valuation</p>
204.24 ~ 27	<p>Stock shall be valued at the LOWER OF cost AND net realizable value → Hence, <i>detailed records of mortality rate and/or periodic sampling on stocking density shall be an integral part of an aquaculture accounting system.</i></p> <p>Foreseeable loss → current estimate of the net realizable value is expected to fetch below its accumulated costs.</p> <p>Base for testing net realizable value</p> <ul style="list-style-type: none"> ✓ Comparing the current average weight valued at current market price with the costs accumulated to date. ✓ Estimate net realizable value at the point harvest/sale in comparison with the estimated total cost (<i>include costs accumulated to date plus estimated costs necessary to complete the cycle</i>). <p>First method is generally considered an INAPPROPRIATE base for estimating net realizable value → rates of weight gain and mortality are different in the grow-out phase. There are species whose market values are insignificant unless they grow out to their accepted saleable size.</p>
	<p>ACCOUNTING FOR AQUACULTURE - Initial investment cost</p>
204.28	<p>Consist of all expenditures whose incurrence are DIRECTLY ATTRIBUTABLE or CAN BE ALLOCATED on a reasonable basis to bring the venture to its operational condition.</p>
204.29	<p>INITIAL expenditures → capitalized as property, plant and equipment and appropriately classified. Their carrying amounts shall be accounted for in accordance with FRS 116.</p>
204.30	<p>SUBSEQUENT improvements → charged to income UNLESS they increase the future benefits from the existing assets beyond their previously assessed standard of</p>

	performance.
	<u>ACCOUNTING FOR AQUACULTURE - Income determination</u>
204.31	Adopt the PROJECT APPROACH by matching costs and revenues of each individual production cycle.
204.32	Revenue from aquaculture operations → recognized at the point of sale.
	<u>ACCOUNTING FOR AQUACULTURE - Stock valuation</u>
204.33	Aquaculture stocks → viewed as stocks of the <i>identifiable cost units</i> → based on the principal that the results of each unit is capable of being measured and evaluated separately.
204.34	Cost of stocks → includes a systematic allocation of production overheads that are considered to relate directly to putting the stocks in the saleable condition. Allocation of fixed production overheads → based on the normal carrying capacity of culture or operation system.
204.35	Aquaculture stocks → valued at the lower of cost and net realizable value.
204.36	Estimates of net realizable value → based on most reliable evidence available at the time the estimates are made as to what the stocks are expected to realize upon completion of the cycle.
204.37	Stocks shall be written down to net realizable value by production cycle since the policy of income determination is based on the project approach.
	<u>DISCLOSURE IN FINANCIAL STATEMENTS</u>
204.38	Accounting policies for the following shall be disclosed: (a) Base adopted for income determination (b) Base adopted for valuing stocks
	<u>EFFECTIVE DATE</u>
123.34	This Standard becomes operative for annual financial statements covering periods beginning on or after 1 September 1998.



AXP TECHNICAL DIAGNOSTIC CENTRE

A CASE STUDY ~

Can the unutilized re-investment allowance carried forward be recognized as “deferred tax assets”?

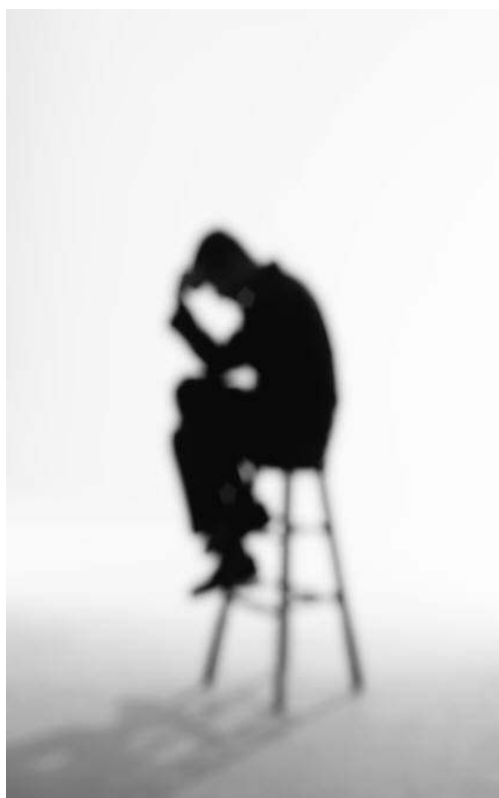


Introduction

On 30 October 2006, MASB issued a policy statement on FRS 112₂₀₀₄ Income Taxes to clarify and re-affirm MASB's position on certain provisions in FRS 112₂₀₀₄, more specifically in relation to re-investment allowance, i.e., whether unutilized re-investment allowance carried forward, or other similar tax incentives can be recognized as "deferred tax assets".



Unutilized re-investment
carried forward
=
Deferred tax assets /
deferred assets?





Standard Reference

Under FRS 112.26, deferred tax asset shall be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

- (a) Is not a business combination; and
- (b) At the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

FRS 112.37 further states that a deferred tax asset shall be recognized for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.

However, there is no definition of “tax credits” under FRS 112₂₀₀₄. Proponents for recognizing the unutilized re-investment allowance was then referred to Paragraph B16 of the Appendix B under FRS 134₂₀₀₄ Interim Financial Reporting which explains tax credits as follows:-

Taxpayers may receive credits against the tax payable based on amounts of capital expenditure, exports, research and development expenditure, or other bases. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated tax rate for the year, because those credits are granted and calculated on an annual basis.

Proponents believe that the unutilized re-investment allowance carried forward meet the definition of “tax credits”, and thus, shall be recognized as deferred tax assets.



MASB's Policy

MASB has stated that unutilized re-investment allowance carried forward does **NOT** meet the definition of deferred tax assets based on the following points:-

- (a) For an asset which qualifies for re-investment allowance or other allowances in excess of its normal capital allowances, a deferred tax asset arises on initial recognition of the asset.
- (b) FRS 112₂₀₀₄ prohibits the recognition of this deferred tax asset (initially and subsequently) as it arises on the initial recognition of an asset or liability in a transaction mentioned in FRS 112.26, as stated above.
- (c) These incentives in excess of normal capital allowances are tax deductions in arriving at taxable profit and are not the same as “tax credit”. The Government is under no obligation to pay or make good any tax incentives that are not utilized by the companies, i.e., the tax benefits could only be realized when the companies make sufficient profits and these incentives are realized and recognized in the years they are utilized to obtain a lower current tax expense as opposed to them being tax credits.

**FRS 112₂₀₀₄ prohibits
recognition of unutilized
re-investment allowances
as deferred tax assets**

~ MASB



A case study ~

Recognize unutilized re-investment allowance as “Deferred assets”

Interestingly, we noted that there was one company listed on the Consumer Products group under the Main Board of the Bursa Malaysia that adopted the following accounting policy:

An asset is recognised when it is probable that such an asset will generate future economic benefits to the Group or the Company and when the amount can be measured reliably. Unutilised reinvestment allowances which are deemed to meet the aforesaid criteria of an asset, are recognised accordingly by way of a credit to the income statement, to the extent of the amount of the deferred liability recognised pursuant to FRS 112 - Income Taxes. When there is a reversal of a deferred tax liability, the deferred asset previously recognised will be correspondingly reversed, in part or in full, by way of a debit to the income statement to the extent of the deferred tax liability reversed.

In the note to the financial statements, it further disclosed that:

Deferred asset represents the tax benefits from the expected utilisation of the unutilised reinvestment allowances in the foreseeable future, based on the prevailing applicable tax rate. The amount that is recognised as an asset is limited to the amount of the deferred tax liability of the Group.

The reinvestment allowance benefits recognised as deferred asset in prior year was RM2.9 million and the reversal of reinvestment allowance benefits during the current financial year was RM5.3 million.

Deferred asset, arising from the unutilized re-investment allowance, recognized in the balance sheet was RM3.9 million and RM9.2 million for the current and previous years respectively.



Conclusion

Definition of assets

Based on the IASB's Framework for the Preparation and Presentation of Financial Statements (*Note: MASB's Framework for the Preparation and Presentation of Financial Statements is still in the exposure draft stage. Please refer to Technical Diagnostic Centre, September 2006 Issue for details*), an asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Thus, to qualify as an asset, three characteristics must be presented:

- (a) Asset must provide probable future economic benefit that enables it to provide future net cash inflows or other benefits.
- (b) Entity is able to receive the benefit and restrict other entities' access to that benefit.
- (c) An event that provides the entity with the right to the benefit has occurred.

Our Comments

Based on the above criteria, it seems that the unutilized re-investment allowance carried forward meets the definition of an "asset".

However, in accordance with ED 53 Framework for the Preparation and Presentation of Financial Statements, where there is a conflict between the Framework and an MASB approved accounting standard, the requirements of the MASB approved accounting standard shall prevail.

Thus, since FRS 112₂₀₀₄ prohibits the recognition of deferred tax assets for unutilized re-investment allowance carried forward, the provisions of FRS 112₂₀₀₄ shall prevail and no recognition of deferred tax assets or deferred assets is allowable.