



# Insights

by Capital Markets & Accounting Advisory Services

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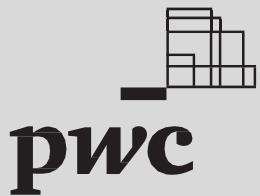
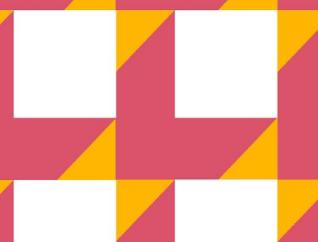
## Accounting items that are often overlooked

### What is the issue?

It is often easier to review accounting entries that have been posted rather than identifying entries that should have been posted but were not. We have compiled a list of key reminders on what not to miss to assist preparers in ensuring the following accounting items are properly reflected in the financial statements:

1. Liabilities for financial guarantees, especially in parent entities
2. Provisions for onerous contracts
3. Provisions for restoration
4. Structured entities - unconsolidated special purpose entities might exist that should be consolidated
5. Implied leases
6. Share-based payment charges in subsidiary financial statements

The accounting standards for the above topics have not been significantly changed recently so this is an opportunity to refocus on the existing guidance that is already effective.



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## What are the matters to look out for?

### (1) Liabilities for financial guarantees, especially in parent entities

#### **What are they?**

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss that it incurs if a specified debtor fails to make payment when due. Such contracts are outside the scope of MFRS 17 "Insurance Contracts" and within the scope of MFRS 9 "Financial Instruments", unless the issuer has previously asserted explicitly that is regards such contracts as insurance contracts and has used the accounting guidance applicable to insurance contracts in the past under MFRS 4 "Insurance Contracts".

#### **What is a common example?**

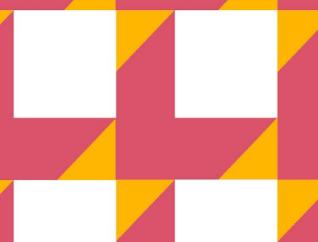
A subsidiary might have obtained a loan from the bank, but the bank required a guarantee from its parent. The parent issued a financial guarantee to the bank, meaning that, if the subsidiary cannot repay the loan, the parent is contractually obliged to step in and make the payment to the bank. Note that a letter of support or comfort letter is not a financial guarantee.

#### **What could be missing?**

Liabilities. Many parent entities applied MFRS 4 as a policy, as opposed to MFRS 9, and do not reflect financial guarantees issued on their balance sheets until a guarantee is triggered (that is, applying MFRS 4 liability adequacy test, consistent with MFRS 137 "Provisions, Contingent Liabilities and Contingent Assets" principles).

On transition to MFRS 17 from MFRS 4, an entity should apply the requirements in MFRS 17 for the first time and, consequently, it can choose to apply either MFRS 17 or MFRS 9 to such contracts. Given the complexities with MFRS 17 accounting, we expect that many non-insurance companies will choose to apply MFRS 9 instead. However, entities that are not already applying MFRS 9 to financial guarantees should be aware that significant work might be required to calculate the MFRS 9 liability. MFRS 9 requires a financial guarantee to be subsequently measured at the higher of (i) the MFRS 9 expected credit loss allowance and (ii) the initial fair value less any cumulative income. This could be a significant change in accounting policy that would need to be applied retrospectively.

So, subject to materiality consideration, under either MFRS 9 or MFRS 17, a liability for the guarantee might now need to be recognised.



## What are the matters to look out for? (continued)

### (2) Provisions for onerous contracts

#### **What are they?**

An onerous contract is defined in MFRS 137 as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Unavoidable costs are the lower of the costs of fulfilling the contract and any compensation or penalties from the failure to fulfil it.

#### **How can they arise?**

Current uncertainty in the economic environment might impact an entity's operations and result in an increased number of onerous contracts. For example, costs to deliver on existing revenue contracts might rise due to inflationary pressures, or benefits expected from existing purchasing contracts might fall due to lower demand, making it difficult to resell committed purchases at a profit.

#### **What could be missing?**

Provisions. A provision under MFRS 137 might need to be recognised that currently is not. However, the term 'economic benefits expected to be received' should usually be construed to include both direct and indirect benefits under the contract. If a provision is required, this should be measured at the amount of 'unavoidable costs' under a contract; these are defined as being the least net cost of exiting the contract. This will be the lower of the cost to exit or breach the contract and the cost of fulfilling it. Finally, an entity should recognise any impairment that has occurred on assets used in fulfilling the contract before an onerous contract provision is recognised.

### (3) Provisions for restoration

#### **What are they?**

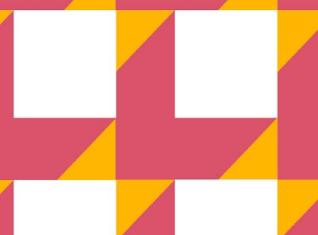
Site restoration provisions should be made in respect of the estimated future costs of closure and restoration, and for environmental rehabilitation costs (which include the dismantling and demolition of infrastructure, removal of residual materials and remediation of disturbed areas) in the accounting period when the related environmental disturbance occurs.

#### **How can they arise?**

For example, some leases allow the tenant to improve the property by adding additional partitioning, but they include obligations on the lessee to return the property at the end of the lease to its original state. This might entail dismantling the improvements.

#### **What could be missing?**

Provisions. Entities might have previously considered that options to renew the lease would be taken continuously, or that the lessor might not require dismantling activities. If there is a change in estimate such that, for example, leases will no longer be renewed over the long term, dismantling outflows might now materialise quicker than expected and perhaps become material for the first time so that a provision under MFRS 137 would need to be recognised.



## What are the matters to look out for? (continued)

### (4) Structured entities - unconsolidated special purpose entities might exist that should be consolidated

#### **What are they?**

Some entities have been designed so that voting or similar rights are not the dominant factor in deciding who controls them: voting rights might relate to administrative tasks only, and contractual arrangements dictate how the investee should carry out its activities; all substantive powers might appear to have been surrendered to contracts that impose rigid control of the entity's activities; they might run on auto-pilot; none of the parties involved in the set-up might appear to have power; but the entities might be indirectly controlled by one of the parties involved.

#### **How can they arise?**

Such entities are typically set up with restricted activities, to achieve a certain narrowly defined objective and they often have thin capitalisation. They might have tax advantages and are sometimes limited in life to also achieve a specified financial objective.

#### **What could be missing?**

Consolidation. When determining if a structured entity should be consolidated under MFRS 10 "Consolidated Financial Statements", one needs to consider the control criterion, which requires an investor to have the power to direct the relevant activities of the structured entity so as to obtain benefits. A key consideration is assessing the design and purpose of such a structured entity and whether the investor has exposure to the risks and rewards of the structured entity. Additionally, careful consideration of the rights of other parties involved, and determination of whether the investor has decision-making rights over the activities of the structured entity is needed.

### (5) Implied leases

#### **What are they?**

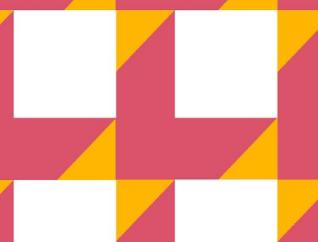
An implied lease refers to a situation where a contract does not explicitly state that it is a lease but where it contains terms and conditions that effectively create a lease arrangement.

#### **How can they arise?**

Arrangements might be entered into that do not take the legal form of a lease but they still convey rights to use assets in return for a payment or series of payments. Examples of such arrangements include service or supply contracts with dedicated equipment, outsourcing arrangements or telecommunication contracts that provide rights to substantially all of the asset's capacity.

#### **What could be missing?**

Right of use assets and lease liabilities. To fall into the scope of MFRS 16 "Leases", there must be an identified asset. However, the asset does not have to be explicitly identified - it can be implicit. If implicit, the asset is not mentioned in the contract, but is implicitly specified in order for the supplier to provide the related goods or services. There is no identified asset if the supplier has a substantive right to substitute the asset throughout the period of use; and, for the contract to contain a lease, the customer must still have the right to obtain substantially all of the economic benefit from the use of the asset throughout the period of use, and to direct how and for what purpose the asset is used.



## What are the matters to look out for? (continued)

### (6) Share-based payment charges in subsidiary financial statements

#### **What are they?**

If employees of a subsidiary have been awarded share-based payments by the parent, MFRS 2 “Share-based Payment” requires a share-based payment charge to be recorded in the subsidiary financial statements.

#### **What is the issue?**

MFRS 2 requires entities to recognise the cost of share-based payment arrangements in respect of their employees even if the entity itself has no obligation to settle them (these would represent equity-settled share-based payment arrangements).

#### **What could be missing?**

A share-based payment expense at the subsidiary separate financial statement level. These arrangements are common in private equity and group situations in which the parent is listed but the subsidiaries are not. In addition to the subsidiary recording the charge, if there is no recharge mechanism, the parent would typically increase its investment in the subsidiary through this scheme.

Do you need further information on this topic?

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