LEMBAGA PIAWAIAN PERAKAUNAN MALAYSIA
MALAYSIAN ACCOUNTING STANDARDS BOARD

MASB Statement of Principles 1
(2004)

Exempt Entities

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Objective

This Statement of Principles is designed to provide guidance to relevant parties as to the applicability to an entity of approved accounting standards issued by the Malaysian Accounting Standards Board as per section 26D of the *Financial Reporting Act 1997*.

Introduction

1. The Malaysian Accounting Standards Board (MASB) has approved the issuance of this Statement of Principles (this Statement) for application to corporate entities. This Statement addresses the circumstances when an incorporated entity is exempted or is required to comply either partially or wholly with the accounting standards issued by the Board.

2. This Statement presents the Board's basis for the reporting obligations that are imposed upon incorporated entities, in particular, exemptions granted to exempt entities due to cost-benefit and other considerations. Whilst the IASB does not address this issue, the treatment presented in this Statement is consistent with the reporting obligations of similar organisations in other jurisdictions.

3. This Statement explores the circumstances in Malaysia under which a corporate entity may be granted compliance exemptions from Financial Reporting Standards. This Statement considers the range of exemptions that may be granted and the factors that determine whether an incorporated entity is eligible for exemption and the type of exemption that may be granted. A further issue addressed here is the manner by which exemptions are granted.

Scope

4. This Statement applies to all entities incorporated within Malaysia (and any subsidiaries or associates) for the purpose of clarifying their reporting obligations under the [*Companies Act 1965*] (sections 165-170) and the *Financial Reporting Act 1997* (section 26D). All incorporated entities are reporting entities unless they meet the criteria set out in this Statement whereupon they may be exempted, wholly or partially, from compliance with Financial Reporting Standards.

Incorporated Entities and the Need to Report

5. There are various types of companies:

   (a) public listed companies;

   (b) public non-listed companies;

   (c) private limited companies; and

   (d) private exempt companies.

6. In Malaysia, the *Companies Act 1965* (see section 165, section 166A and the Eighth Schedule) requires all registered companies (except private exempt companies) to submit to the Registrar of Companies (ROC) annual audited accounts prepared in accordance with approved accounting standards. Whilst private exempt companies are granted relief from submitting reports to the ROC, Financial Reporting Standards are by the legislation, deemed to apply to private exempt companies as the Eighth Schedule requires that audited accounts must be laid before the annual general meeting. Strictly speaking, those audited accounts shall be prepared on the basis of Financial Reporting Standards. However, it is acknowledged that there may be circumstances where the full application of Financial Reporting Standards is not necessary.

7. The special legal nature, size and activities of incorporated entities give rise to the need to monitor their activities on several levels. Therefore, the purpose of the publication of annual reports is to monitor and regulate the activities of incorporated entities. This is usually in the form of audited annual accounts prepared in accordance with approved accounting standards. Information in these reports is presented for the benefit of report users so that they can make informed economic and public policy decisions. The fact that in most instances, certain entities do not have a constituent group of financial report users means it is difficult to justify the publication/disclosure of general purpose financial reports by such entities.

8. In its deliberations on this issue the MASB has considered the MASB's *A Proposed Framework for the Preparation and Presentation of Financial Statements* (Framework), legislative and business circumstances within Malaysia and has taken into consideration similar treatments in other jurisdictions.

Background Discussion

9. The contents of an accounting standard comprise provisions concerned with accounting treatments in the preparation of financial statements and those provisions concerned with the disclosure and display of items in those statements. Consequently, there are two approaches to consider in a decision to grant exemptions from Financial Reporting Standards. Potentially, exemptions might constitute relief from accounting treatments contained in the standards and/or relief from disclosure provisions of the standards. Any decision to exempt a reporting entity from the Financial Reporting Standards may be based upon either a full or a partial exemption from the provisions of the standards. There are several possible combinations that may be applied in the decision to exempt.

10. Full exemption from the provisions will mean that the reporting entity is not obligated to comply with either the provisions regarding treatments or disclosures. A partial exemption may provide relief for compliance obligations in several ways. For example, an entity may be obligated to comply with accounting treatments in the preparation of the reports but is not obligated to make the full extent of disclosures as provided by the standards. Another possible approach is to exempt the entity only from some aspects of either treatment or disclosure provisions. The extent of exemption may depend upon the circumstances of the reporting entity. These possibilities are summarised in Table 1 below.

Table 1 Extent of Exemption from Financial Reporting Standards

Type of Exemption	Treatment	Disclosure
Full	Exemption	Exemption
Part	Exemption	Partial exemption
Part	Exemption	No exemption
Part	Partial exemption	Exemption
Part	Partial exemption	Partial exemption
Part	Partial exemption	No exemption
Part	No exemption	Exemption
Part	No exemption	Partial exemption

11. A second aspect to consider is the manner by which qualifying entities are granted exemptions from Financial Reporting Standards. Methods by which exemptions can be granted include:

    (a) by way of a block exemption;

    (b) on a standard by standard basis; or

    (c) by the application of a designated standard for eligible entities.

12. Exemption by way of a block exemption is the broadest approach that the MASB can adopt. Under such an approach, incorporated entities are automatically exempted from all treatment and disclosure provisions in all standards.

13. A second alternative is for the consideration of exemptions on a standard by standard basis. In such an approach, the issue of exemption is determined in the developmental phase of each individual Financial Reporting Standard. Where it is considered appropriate, exemptions or exceptions may be applied to qualifying entities. Notification of any exemption is usually placed in the scope of the standard.

14. The third approach is the development and promulgation of a separate Financial Reporting Standard to guide the preparation of financial statements for the qualifying entities. In other jurisdictions such an approach is referred to as differential reporting. An example of differential reporting is *Financial Reporting Standard for Smaller Entities* (FRSSE) issued by the Accounting Standards Board in the United Kingdom (UK) in November 1997 (subsequently revised in December 1998). This standard prescribes the basis for the preparation and presentation of financial statements of those entities that fall within its scope. In effect, such an approach is a partial exemption as the purpose of the standard is to draw into a single location, all of the provisions and treatments contained in the standards which are regarded as applicable to qualifying entities. The benefits of such an approach are that preparers will only need to search one location for applicable rules and the treatments contained therein will be simplified and, therefore, more suitable to such entities. In addition, such a standard might exclude some of the disclosure requirements contained in other standards.

Qualifying Circumstances

15. Based upon the above discussion, it is necessary to determine the circumstances upon which an entity might qualify for full or partial exemption from Financial Reporting Standards. This issue has been considered in several other jurisdictions where the treatment can provide some guidance to the development of principles suitable for application in Malaysia.

16. In the UK a consultative document was issued in November 1994 proposing that, with the exception of certain specific accounting standards, the Accounting Standards Board shall exempt from compliance with accounting standards all entities that met the Companies Act (UK) definition of a small company. While the comments to that document indicated support for the use of the small companies threshold and for some changes to the existing system whereby small entities were required to comply with almost all accounting standards, there was no clear support for piecemeal application of accounting standards.

17. A second UK paper, issued in 1995, focused on the needs of smaller entities. This paper proposed that there shall be a specific *Financial Reporting Standard for Smaller Entities* (FRSSE). In view of the overwhelming support for the proposal, the Accounting Standards Board issued the FRSSE which prescribes the basis for preparing and presenting financial statements for those entities within its scope that have chosen to adopt the FRSSE.

18. Under this current regime in the UK, exemptions are given based on size or a combination of size and public interest, with the use of the "small company" ceiling in section 247 of the *UK Companies Act 1985*. In addition, the UK legislation also provides exemption to "small groups".

    Public interest criteria as provided in section 246 include:

    - A banking or insurance company
    - A body corporate that (not being a company) has the power to offer its shares or debentures to the public and may lawfully exercise that power
    - An authorised institution under the banking regulations
    - An insurance company under the relevant insurance regulations
    - An authorised person under the financial services regulations

19. The development in New Zealand follows a similar stance. It has issued a *Framework For Differential Reporting* (revised 1997) setting out criteria under which entities qualify for differential reporting exemptions. The New Zealand Framework also acts as a guide for those who set accounting standards to establish differential reporting exemptions in those accounting standards.

20. The New Zealand Framework refers to those entities that qualify for exemptions as qualifying entities. A qualifying entity is defined in the *New Zealand Framework for Differential Reporting* as an entity which does not have public accountability, and: (i) at balance date, all of its owners are members of the entity's governing body; or (ii) it is not large. An entity is large if it exceeds any two of the following: (a) total revenue of NZ$5 million; (b) total assets of NZ$2.5 million; and (c) 20 employees. However, an entity which does not have public accountability but whose parent or ultimate controlling entity has the coercive power to tax, rate or levy to obtain public funds may only qualify as "qualifying entity" if it is not large.

21. Generally, the approach to defining reporting entities adopted in Australia is of some, though limited, relevance to Malaysia as the Australian Accounting Standards Board is concerned with a broader definition of reporting entities which is not based upon incorporation but instead upon the existence of dependent user groups. Entities other than incorporated bodies may be defined as having a dependent user group to whom general purpose financial reports shall be made available. However, the Australian corporations law does provide some guidance because it relieves small proprietary companies from reporting and audit obligations. Class orders issued by the Australian Securities and Investments Commission also provide some relief to wholly-owned subsidiaries and to foreign proprietary companies in certain circumstances. The qualifications for relief provided under the corporations law are not dissimilar to those applied in the UK or New Zealand.

22. Variations in the legislative environment and audit requirements of the United States (US) means that the manner by which exemptions from compliance with FASB standards are granted has limited applicability to Malaysia. For example, in the US there is no companies legislation defining public as opposed to private corporations. Corporations must comply with the provisions of FASB standards once they are listed on a capital market.

Cost-Benefit Issues

23. Cost-benefit criteria are met when the benefits of financial accounting and reporting requirements outweigh the costs borne or imposed upon the entity in the preparation of financial reports.

24. The costs of financial accounting and reporting are mainly incurred by the reporting entity, though information users and standard setters also incur costs. Paragraph 65 of the Framework provides that the benefits derived from information shall exceed the cost of providing it. It is also acknowledged in the Framework that the evaluation of costs and benefits is substantially, a judgemental process. The difficulty in a cost-benefit analysis is that the costs and especially the benefits are not always evident or measurable.

    It is generally accepted, however, that the benefits will usually increase with:

    (a) the number and diversity of users;

    (b) the satisfaction of their information needs; and

    (c) the existence of qualitative characteristics of the information, such as reliability, relevance and timeliness.

Defining an Exempt Entity

25. This Statement adopts a concept of a reporting entity, which amongst its considerations, is tied to the information needs of users and the nature of general purpose financial statements. The definition of an exempt entity is developed on the assumption that certain entities in different circumstances may be exempted from accounting practices and financial reporting disclosures set out in Financial Reporting Standards for various reasons including lack of dependent users.

26. The need to prepare general purpose financial statements is linked to the existence of dependent users who rely on those statements as a basis for making and evaluating resource allocation decisions. Either size or the ownership characteristics of an entity do not necessarily determine the existence of dependent users. Certain features may be identified which can act as indicators of circumstances where dependent users exist for such entities. In the case of entities that do not possess such features, it is reasonable to expect such entities not having dependent users and, therefore, may qualify as exempt entities.

When there is an absence of dependent users, the use of 'benefits versus costs of compliance with financial reporting standards' criterion is not substantiated. Generally, the MASB has sought to adopt a broad approach to the issue of defining exempt entities. The following discussion provides an explanation of the rationale and application of these assumptions/concepts.

27. In arriving at a definition of exempt entities, this Statement employs surrogates to determine if an entity has dependent users, based on the broad assumptions listed below:

    (a) more benefits are derived from the general purpose financial statements of entities with public accountability because such entities' financial statements are likely to have dependent users;

    (b) there is generally no accountability requirement when all of the owners of an entity are also members of its governing body. However, where the owners and the governing body of an entity are different, an accountability requirement may arise, as there are likely to be dependent users. In this case, the value of the entity's general purpose financial statements to users may be expected to increase, and greater benefit is likely to be derived; and

    (c) whilst the MASB does not believe that the path to providing exemptions shall be based solely upon size, in general, the larger the entity the more likely the existence of dependent users. This will usually result in a more extensive group of users benefiting from the information provided in the general purpose financial statements and, therefore, greater benefits are likely to be derived.

Public Accountability

28. Public accountability can be deemed to exist where it is likely that there may be sufficient stakeholders who base their resource allocation decisions upon their knowledge of the entity. Financial statements communicate much of this knowledge. The stakeholders include resource providers (including employees), recipients of goods and services, and parties performing review or oversight functions. The existence of sufficient numbers of dependent users in these categories would suggest justification for the preparation of annual financial statements based upon relevant approved accounting standards.

29. Further, when an entity possesses certain authority or enjoys a particular position in society, there is deemed to be an accountability relationship between the entity and the public i.e. public accountability. An entity that was at any time during the current or the preceding reporting period, a public company or a subsidiary or an associate of a public listed company is deemed to have public accountability by virtue of the fact that it raises funds from the public. Such fund raising may be through issue of capital or debentures or the like.

30. If the parent or ultimate controlling entity has the coercive power to tax, rate or levy to obtain public funds, the entity is not permitted to use a lack of separation between the owners and the governing body as a basis for qualifying as an " exempt entity". Such entities may qualify as "exempt entities" only on the basis of size. It is not appropriate that entities such as state-owned entities, or privatised companies be exempted on the basis of lack of separation between the owners and the governing body. The public has a beneficial interest in these entities and in many cases the public indirectly provides funds to such entities through taxes, rates or levies. For an entity that is accountable to the public at large it is reasonable to expect that there will be dependent users for example investors, taxpayers and ratepayers.

Separation between Owners and Governing Body of an Entity

31. Separation between owners and the governing body is another surrogate to indicate the existence of dependent users. Where the owner is not part of the body that makes the operational and financing decisions relating to the entity, he may not be privy to certain information that is considered necessary to make efficient resource allocation decisions. In such instances, the owner is reliant upon the general purpose financial statements as the source of information. Hence, it is reasonable to expect dependent users to exist in such circumstances.

32. Where every owner of an entity is also a member of the entity's governing body, there is an absence of accountability relationship between the governing body and the owners. In such circumstances subject to paragraph 35, the entity will be an "exempt entity", provided it is not publicly accountable.

33. Where an owner of an entity is not a natural person (for example, the owner is a company or a trust) and the owner appoints a representative to the governing body, that representative is considered to be an owner for the purposes of this Statement. For example, in the case of a wholly owned subsidiary, the directors appointed by the holding company are considered to be the owners of the subsidiary. In the case of a joint venture company, all parties involved in the venture shall appoint a representative to the Board of the joint venture company. If not, there will be some parties who will require the general purpose financial statements making them dependent users.

34. Owner is defined as a party that has a beneficial interest in the residual value of the entity's net assets. Therefore, when the entity preparing the financial statements is a trust, all beneficiaries must be trustees in order to meet the requirement that there is no separation between the owners and the governing body. In the case where a trust has an interest in another entity all the beneficiaries of the trust shall be included in the governing body of the other entity, otherwise it is considered to possess dependent users.

Size

35. When an entity is large, it is deemed likely to have dependent users by virtue of the discussion in paragraph 28. For the purposes of applying Financial Reporting Standards an entity is large if it exceeds any two of the following:

    (a) an annual gross revenue of 10 million;

    (b) gross assets of 5 million at the end of the financial year; and

    (c) an average of 50 employees for the financial year.

    For any entity, other than a newly incorporated entity, the conditions must have been satisfied in two of the last three preceding years. When an entity has been large and subsequently ceases to be large, the entity does not qualify as an exempt entity until the entity ceases to be defined as large for two consecutive reporting periods.

    It is intended that the criteria for size will be reviewed from time to time to reflect changes in the business environment. However, when the criteria for size have been amended, an entity may apply the revised criteria for size in the first year of application and qualify as an exempt entity.

Groups of Entities

36. Where the reporting entity is a group, the criteria in paragraphs 28 to 35 shall be applied to the group comprising the investor, its subsidiaries and associates. For a group, the criteria for size in paragraph 35 shall be applied to the totals of an actual or notional consolidation. When the parent of the group issues consolidated financial statements, the group is considered to be the issuer and hence, may be deemed publicly accountable in terms of paragraphs 28 to 30.

Definition of an Exempt Entity

37. Based upon the preceding discussion, the definition developed is on the basis of the following assumptions:

    (a) compliance with approved accounting standards creates costs (usually for the reporting entity) and benefits (usually for users of the financial reports);

    (b) compliance shall be required only when the benefits of compliance exceed the costs;

    (c) approved accounting standards will be more accepted if they apply only where benefits are generally agreed to exceed costs; and

    (d) where dependent users are unlikely to exist for an entity, it is reasonable to assume that benefits will not outweigh costs.

38. An entity is an exempt entity when:

    (a) the entity does not have public accountability in accordance with paragraphs 28 to 30;

    (b) at balance sheet date, all of its owners are members of the entity's governing body in accordance with paragraphs 31 to 34; and

    (c) the entity is not large in accordance with paragraph 35.

    Hence, all entities that fail to meet any one of the above criteria do not qualify as "exempt".

Application of these criteria is demonstrated in Appendix 1.

Basis for Exemption

39. In paragraph 11 it was noted that there are three methods by which exemptions may be granted. Full or block exemption means that exempt entities are not required to comply with either accounting treatment or disclosure provisions of Financial Reporting Standards. However, for full exemption to be workable, such entities shall also be exempted from the requirement to submit annual audited accounts. Nonetheless, the requirement for the preparation and submission of annual audited accounts has been legislated and there are several merits in this requirement as it forces companies to maintain proper records and accounting systems so as to enable them to submit the yearly accounts in compliance with approved accounting standards. This is because for companies to comply with the *Companies Act 1965*, they need to prepare accounts in accordance with Financial Reporting Standards and auditors have to report whether those accounts have been prepared in accordance with the approved accounting standards.

40. A further option listed in paragraph 11 is the application of a designated Financial Reporting Standard for exempt entities. This proposal is based upon the approach adopted in the United Kingdom. A designated standard would effectively replace all other standards as it would include all of the accounting treatment and disclosure provisions considered relevant to financial reports by entities defined as exempt. The contents of such an exempt entity standard would be simplified and less onerous than the individual Financial Reporting Standards.

41. The MASB is generally of the view that it is not appropriate to grant qualifying entities full exemption from both the accounting treatment and disclosure provisions of its accounting standards. The MASB has not at this stage considered the development of a separate standard to guide the preparation and presentation of exempt entity reporting. After considering the issues discussed above, the Board has decided that the most appropriate decision is to grant partial exemptions on a standard by standard basis. The presumption is then, that all incorporated entities must follow Financial Reporting Standards in the preparation of their financial statements unless the provisions of that standard specifically exempt them. This decision may be reviewed in the future after the Board undertakes further research.

42. Partial exemption relates to providing exemptions to exempt entities based on considerations of cost-benefit criterion. As each specific accounting standard is developed, the relevant working group and subsequently the MASB will consider the accounting treatment and disclosure requirements and provide exemptions based on careful consideration of the circumstances of these exempt entities.

43. Decisions made in the due process of the MASB about exemptions will give consideration to the benefits and costs that may arise. For those entities to which exemptions shall be considered, particular attention will be given to the costs of compliance to the entity. Costs have been identified to include, amongst others: costs of collecting and processing information; costs of disseminating; costs of auditing; and costs of analysis and interpretation. The final decision with respect to an exemption and its extent will be based upon a balance of beneficial disclosures and compliance costs.

Effective Date

44. This Statement shall be adopted as soon as practicable but in any event must be used in the application of approved accounting standards for the preparation of financial statements as per the effective date(s) of those individual standards.

Appendix 1

Criteria to Establish an Exempt Entity