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# Changes to the Ethics Code: Revisions to the Definitions of Listed Entity and Public Interest Entity

**at-mia.my**/2023/06/23/changes-to-the-ethics-code-revisions-to-the-definitions-of-listed-entity-and-public-interest-entity
June 23, 2023

*By MIA Capital Market and Assurance Team*

In January 2021, the International Ethics Standards Board for Accountants (IESBA) issued an exposure draft (ED) seeking to redefine public interest entities (PIE). The proposals, amongst others, sought to introduce an overarching objective for additional independence requirements for audits of PIEs, provide guidance on factors for consideration when determining the level of public interest in an entity and expand the extant definition to some categories of entities, subject to refinement by the relevant local bodies.

Titled "Proposed Revisions to the Definition of Listed Entity and Public Interest Entity in the Code" with a comment period up to 3 May 2021, the IESBA received a total of 69 comment letters from various stakeholders including the MIA's Ethics Standards Board (ESB). The process culminated in the finalisation of the pronouncement issued on 11 April 2022 and will be effective for audits of financial statements for periods beginning on or after 15 December 2024, with earlier adoption permitted.

For Malaysia, it should be noted that there is already an expanded list of PIEs as determined by the Securities Commission under Schedule 1 of the Securities Commission Malaysia Act 1993 (SCMA). However, with the issuance of the final pronouncement, the ESB has begun the process of considering the application of the pronouncement in the local environment while working towards the same global adoption date.

## Why is the new definition relevant and why now?

In recent times, the IESBA was driven by its own observations of inconsistent practices across jurisdictions and stakeholder feedback. The extant definition of PIE has limitations in its approach and furthermore, it did not provide stakeholders with clear guidance specifically on which entities should be considered as PIEs. It was then decided that it would be timely for the definition to be re-examined since it was first introduced back in the early 2000s.

By enhancing the definition of PIE, the IESBA could now provide better clarity and guidance to the concept it seeks to establish as well as align the PIE scope with the recently effective revised non-assurance services and fee-related provisions. The changes also recognise the role local authoritative bodies will need to play in refining the definition to fit their jurisdictions.

## What are the salient features of the revised provisions?

### An Overarching Objective

With the introduction of an overarching objective, the Code now explains the purpose of additional independence requirements for PIEs. The IESBA acknowledged that having an overarching objective to form an overall approach would then also provide a clearer principle for stakeholders to refine and determine which entities should be categorised as PIEs in the local code.

In general, the provisions drive home the notion that if there is a significantly greater public interest in an entity's financial condition, there would be proportionate expectations of the independence of a firm performing the audit of a PIE and hence, the need for additional independence requirements. The provisions also provide greater details of the factors a professional accountant should consider in evaluating the level of public interest in the financial condition of an entity.

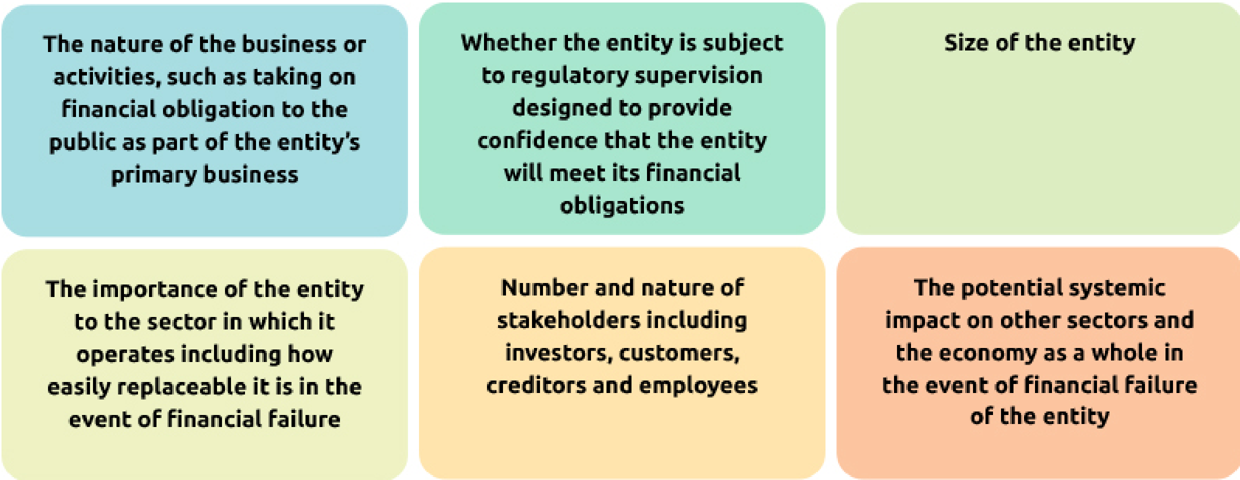
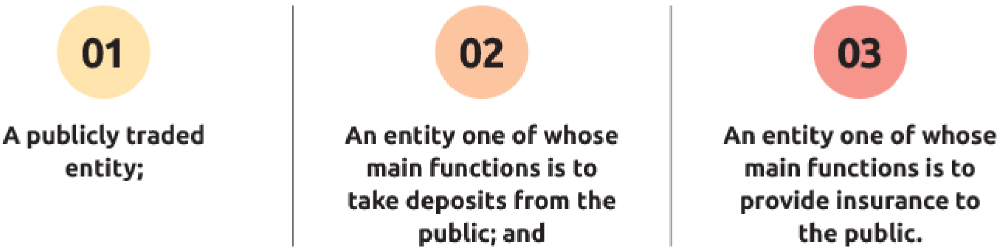


***Figure 1:*** *Factors in evaluating the level of public interest.*

**Redefining PIEs and establishing the role of local authoritative bodies and firms to refine the PIE categories**

The revised provisions now take a broader approach in contrast to the extant provisions. The standard now sets out 3 mandatory PIE categories determined by the IESBA which are:




The term "publicly traded entity" is introduced as a replacement of the term "listed entities". It is defined in the provisions as an entity that issues financial instruments that are transferrable and traded through a publicly accessible market mechanism, including through listing on a stock exchange.

The provisions then establish that the relevant local bodies will play their part in refining the list either by adding or exempting particular categories to ensure the list of PIE categories is fit for purpose in a local setting. To refine this list, the relevant local bodies would be guided by the overarching objective, the list of factors set out above (see **Figure 1**) and make reference to the examples (large private companies, pension funds, public utilities and etc.) provided in the provisions. The IESBA rationalised that relying on local authoritative bodies such as local regulators, national standard setters or other relevant bodies would be the most practical approach as these bodies are best placed to assess and determine which entities fit the PIE definition.

Similarly, at the firm level, the provisions now recognise the role firms have and encourage firms to determine if any other entities should be treated as PIEs. It further sets out additional, more granular factors that may be considered in determining if other entities (apart from the mandatory categories and those determined by local authoritative bodies) should be treated as PIEs.

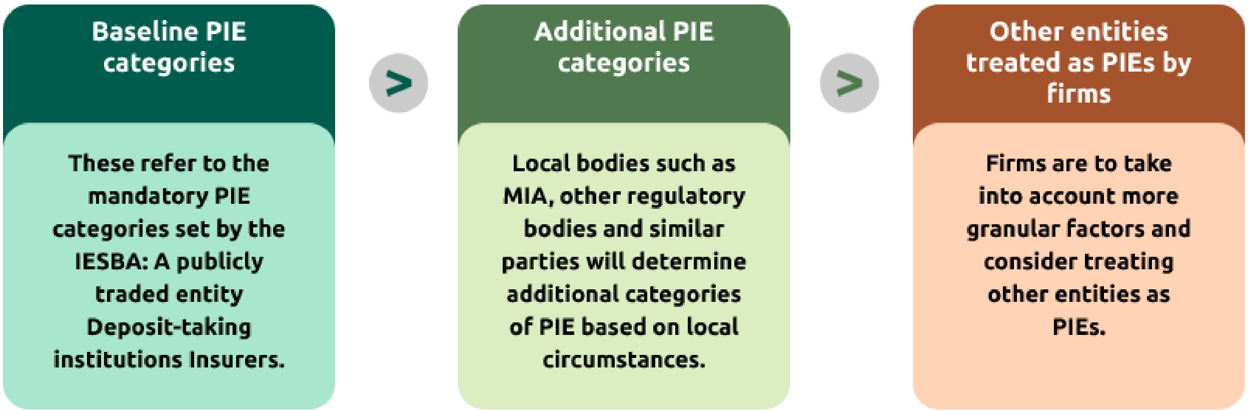


***Figure 2:*** *Framework for determining PIE categories*

**Recognising the importance of transparency**


The revised provisions also clarify the requirement for firms to publicly disclose if they have applied the independence requirements for a PIE to an audit client considering the timing and availability of the information to stakeholders. This is different from the initial proposal in the ED which instead required the firm to disclose if an audit client was treated as a PIE.

The IESBA acknowledged upon receiving comments from its respondents that the initial provision would give rise to confusion among stakeholders who may interpret that there are different levels of independence and that non-PIE audits are of lower quality and provide lesser assurance.

The IESBA therefore determined to revise the objective of the transparency requirement to instead disclose if independence requirements have been applied in performing an audit of the financial statements of an entity. No examples and guidance have been provided on the mechanism of disclosure at this point in time as there is a need for the International Audit and Assurance Standards Board (IAASB) to also weigh in and conclude on this matter before appropriate examples can be given.

The provisions do, however, clarify that the disclosure should be made in "a manner deemed appropriate taking into account the timing and accessibility of information to stakeholders". Additionally, if it would involve revealing confidential future plans of the entity (e.g. upcoming initial public offerings and etc.), the provisions allow for the disclosure to be exempted.

## What are the additional independence requirements relating to audits of a PIE?

The IESBA's Code of Ethics and by extension, the MIA By-Laws which are substantially based on the Code, contain numerous provisions which either prohibit or require necessary safeguards to be applied in the event firms are considering to enter into certain relationships or business interests with PIEs. This is due to the significant level of threats to independence that would be created as a result of these relationships. With the enhancements resulting from the revised provisions, it is important that the professional accountant re-familiarise themselves with the additional independence requirements applicable when working with PIE clients. These requirements can be summarised as follows:

#### Restrictions on non-assurance services

Firms may face restrictions on providing certain non-assurance services to their PIE audit clients if a self-review threat arises. This is due to the level of threats created if a firm audits its own work.

These non-assurance services can be categorised as follows:

- **Permitted to provide as it does not usually create a self-review threat**
    - Administrative services (when clerical in nature and require little to no professional judgement)
    - Tax return preparation services
    - Recruitment services where the firm will not assume a management responsibility such as reviewing the professional qualifications of applicants and providing advice on their suitability for the role and interviewing candidates and advising on a candidate's competence for financial accounting, administrative or control positions.

- **Prohibited if it might create a self-review threat**
    - Valuation services
    - Tax advisory and tax planning services
    - Tax services involving valuation
    - Assistance in the resolution of tax disputes
    - Internal audit services
    - Information technology systems services
    - Litigation support services
    - Legal advice
    - Corporate finance services

- **Prohibited**
    - Accounting and bookkeeping services
    - Tax calculations of current and deferred tax liabilities (or assets)
    - Assistance in the resolution of tax disputes if the service involves acting as an advocate
    - Acting as an expert witness (unless under certain circumstances set out in the Code)
    - Acting in an advocacy role in resolving a dispute or litigation before a tribunal or court
    - Recruitment services which require the firm to act as a negotiator or which relate to:
        - searching for or undertaking reference checks of prospective candidates;
        - recommending the person to be appointed; or
        - advising on the terms of employment, remuneration or related benefits of a candidate who is a director or officer or senior management who has influence over accounting records or financial statements.

In addition to this, pre-concurrence from those charged with governance on the non-assurance services (NAS) provided by the firm to a PIE is also required. This step ensures those charged with governance of the PIE audit client will carry out the necessary oversight over the independence of the firm auditing the financial statements.

#### Restrictions on fee dependency

As a result of self-interest and intimidation threats created by having a client represent a large proportion of the total fees of a firm, the fees earned by a firm from a PIE client should not make up more than 15% of the firm's total fees for 2 consecutive years or the affected firm will be required to consider undertaking a pre-issuance review as a safeguard. Firms are also required to communicate to those charged with governance on whether this situation is likely to continue, the safeguards that have been applied and if there is any proposal to continue as the auditor. This is again to ensure those charged with governance are able to consider the independence of the firm.

#### Rotation of partners

Due to familiarity threats arising from long associations with an audit client, engagement partners, other key audit partners and engagement quality reviewers who have worked on an audit of a PIE for more than 7 cumulative years ("time-on" period) must observe a "cooling-off" period of 2 to 5 years depending on their roles. "Cooling-off" involves ceasing to act in any of the aforementioned roles or a combination of such roles for the PIE.

## Concluding thoughts and further reading

Overall, the revised PIE provisions set out to bring greater clarity to the concepts of PIEs and listed entities while reflecting the latest developments in the capital markets and ensuring these concepts always remain fit for purpose. The provisions represent a significant step in maintaining public trust and underscores the vital role that audit firms and local authoritative bodies play in maintaining independence, objectivity, and integrity when working with public interest entity clients.

Members who wish to know more about the upcoming standards are able to view the "Basis for Conclusions" publication issued by the IESBA in April 2022 on their website.

The IESBA staff has also recently released a questions and answers (Q&A) publication to highlight this pronouncement on their website and is noted to be working on issuing further guidance such as infographics and a jurisdictional PIE database. The MIA's ESB will share these upcoming resources with members as and when they are made available. As always, members are reminded to stay informed and be guided accordingly with any new developments.

# Clarification on case decision in Courts: Wong Ching Yong v Malaysian Institute of Accountants

at **at-mia.my**/2023/06/19/clarification-on-case-decision-in-courts-wong-ching-yong-v-malaysian-institute-of-accountants
June 19, 2023

*By MIA Surveillance and Enforcement*

### BRIEF FACTS

- A Notice of Complaint was issued to Wong Ching Yong ("**WCY**") by the Malaysian Institute of Accountants ("**MIA**") following a review conducted on WCY by the Practice Review Committee.
- On or about 28.9.2017, a mention was held by MIA's Disciplinary Committee ("**the DC**") for the complaint against WCY whereby the charge was read to WCY.
- During the mention, WCY admitted that he understood the charge and pleaded guilty/admitted to Part A of the charge (being the factual portion of the charge) and wanted to be heard on Part B of the charge. Thus, the DC had set a date for a further hearing date of the matter.
- On or about 27.3.2018 a hearing for the charge against WCY was conducted by the DC whereby WCY was represented by advocates. WCY confirmed his admission to Part A of the charge during the hearing. Furthermore, WCY and his advocates were given their chance to be heard on Part B of the charge.
- On 3.9.2018, the DC had found that WCY was guilty of the charge against him.
- On 3.10.2018, WCY had filed an appeal against the whole decision of the DC to the MIA's Disciplinary Appeal Board ("the DAB").
- On 13.6.2019, the DAB had upheld the decision of the DC.
- On 11.9.2019, WCY applied for leave to commence judicial review against the decision of the DC and the DAB.

### JUDICIAL REVIEW AT THE HIGH COURT

- The procedure of Judicial Review is not a challenge to the correctness of the decision made but instead a challenge to the procedure adopted in the decision-making process at the Disciplinary Committee.
- The High Court had dismissed WCY's application for Judicial Review. In doing so, it had decided:-
- There was no failure of quorum.
- There was only one charge as Part A and Part B are tied to the same fact which is WCY's breach of ISA 230 and ISA 500.

- WCY had pleaded guilty so there was no need for a full trial.
- Rule 16 of the Malaysian Institute of Accountants (Disciplinary) (No. 2) Rules 2002 does not apply as the factual basis of the charge is not disputed and has been admitted.
- WCY had been given the right to be heard on 27.3.2018.

## WCY'S APPEAL TO THE COURT OF APPEAL

- Dissatisfied with the decision of the High Court, WCY had filed an appeal on 14.2.2020.
- On 21.6.2022, the Court of Appeal had allowed WCY's appeal against the decision of the High Court.
- The Court of Appeal had not provided any detailed grounds of decision despite requests for the same. However, the Court of Appeal decided as follows:-

  *"Having considered the submission of the parties, we are in the agreement with the submission of the learned counsel of the Appellant. We find that there is appealable error committed by the learned Judge the High Court that warrant appellate intervention. We agree that there is occurrence of procedural impropriety and breach of natural justice against the Appellant by the DC. As a result, the decision of the board is tainted and flawed. The learned High Court has erred on this and for not allowing the JR application. We find merit in the JR application. We therefore allow the appeal of the Appellant with cost. We set aside the order of the High Court, the JR is allowed as per prayer sought herein. The decision of the DC and Board is set aside…"*

Comment:- the principle in this decision was that since the Respondent had only agreed to the plea of guilt for Part A but did not agree for Part B, the Court considered that it was a qualified plea and not absolute. Thus, the DC ought to have conducted a full proceeding by calling witnesses.

## MIA'S APPLICATION FOR LEAVE TO APPEAL TO THE FEDERAL COURT

- On 19.7.2022, MIA had applied for leave to appeal to the Federal Court raising a few questions of law by virtue of exclusive jurisdiction of the Federal Court in Article 128(1) Federal Constitution – to determine (a) any question on the validity of law made by Parliament or by the legislature of a state; and (b) disputes on any other question between states or between the Federation and any state.
- Upon hearing the application on 16.5.2023, the Federal Court dismissed MIA's application. No detailed grounds/reasons were provided for the dismissal as of now despite a written request to the Federal Court.

# Clarification on issues related to Practice Review Programme

at-mia.my/2023/06/19/clarification-on-issues-related-to-practice-review-programme
June 19, 2023

*By MIA Surveillance and Enforcement*

### 1.0 Establishment of Practice Review Programme (PRP)

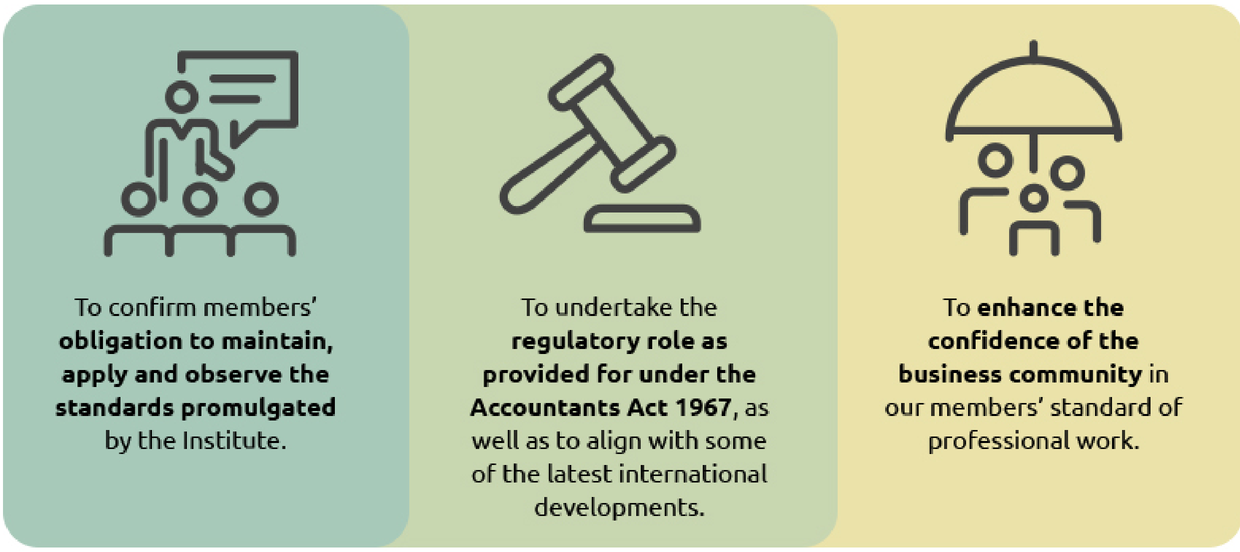
- As a member of the International Federation of Accountants (IFAC), it is incumbent upon the Malaysian Institute of Accountants (MIA) to implement the PRP for its member firms. The PRP forms the substance of the Statements of Membership Obligations (SMOs), particularly SMO 1 – Quality Assurance.
- As stated in Section B250: Quality Assurance and Practice Review of the By-Laws of MIA, MIA has established its PRP pursuant to the Council's Statement on Practice Review issued on 15 November 2002 together with its supporting appendices which are set out in Appendix VI to these By-Laws. It assesses the standards and procedures of members' audit practice to ensure compliance with applicable professional standards, legal and regulatory requirements.

The professional standards which are required to be observed and applied include:

- all standards and statements of professional conduct and ethics in the form of the Institute's By-Laws issued from time to time; and
- all approved standards whether issued by the Council or otherwise, and all guidelines, statements and/or circulars of best practices issued or prescribed by the Council and/or the Institute from time to time.

### 2.0 Objectives of PRP

The objectives of PRP are three-pronged:




### 3.0 Practice Review Framework

The Practice Review (PR) Framework serves as the foundation for the surveillance activities conducted by the PRD. The framework outlines the approach used for selecting audit firms to be reviewed, as well as the scope of the reviews and the types of ratings used to evaluate the firms.

Our framework involves identification and analysis of internal and external factors that influence how auditors fulfil their responsibility. It is thus imperative for audit firms to undertake an in-depth analysis of their firms to identify root causes that may result in deterioration of audit quality. Practice review considers Root Cause Analysis (RCA) to be part of a continuous audit quality improvement process, which includes other elements, namely remediation, monitoring and measurement.

## Firm Selection Process

- MIA uses a risk-based approach for selection of audit firms for practice review, which has been streamlined under the Revised Practice Review Framework, to select firms based on a risk profiling system using information extracted from the Annual Return submitted by Audit Firms. The cycle ratio for PR on firms is once within a period of 6 years unless there are referrals from other Regulatory bodies or Committees of the Institute.
- Audit firms may also be selected for review based on referrals from other Regulatory bodies in Malaysia or other Committees of the Institute.
- The identity of the audit firm is kept confidential at all times from all parties who are not directly involved in the practice review of the firm, including the Practice Review Committee (PRC) and staff of the Institute.

## Scopes of Review

- Firm-level Inspections – Practice Review inspects the audit firm's system of quality control (firm-level inspections) to ensure that they are in compliance with the requirements of ISQM 1.
- Engagement Inspections – Practice Review's approach in performing inspections of individual engagements comprises detailed engagement inspections of audit firms to assess whether the audit work is conducted in compliance with relevant professional standards. For practical reasons, not all partners of an audit firm that have been selected for practice review will be reviewed individually with regards to the current audit engagement files.
- However, in most circumstances, the sample of files selected for practice review should be reflective of the firms' overall operations and size.

## Practice Review Outcome - Ratings Determination Process

- At the conclusion of the practice review, the reviewer is required to table a report to the PRC.
- Before the deliberation of the report, the reviewer will delete any reference to the audit firm's identity to preserve confidentiality.
- The PRC shall determine a rating for the report in the following manner, taking into consideration the practice review report and the audit firm's comments.

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### STEP 01 Satisfactory

- Where it is determined that no or minimal weaknesses were observed.
- The audit firm has adequately complied with applicable professional standards, legal and regulatory requirements in the performance of its work.

***Type 1** signifies a comfortable pass and no further action is required.*

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## STEP 02 Assurance on Compliance Required

- Where it is determined that the audit firm has some significant weaknesses which were not pervasive.
- Weaknesses are noted in some engagements but not in others in complying with applicable professional standards, legal and regulatory requirements in carrying out the work in certain areas of the engagements reviewed.

***Type 2** requires a written assurance and commitment from audit firms that they will implement remedial action and improvement to address the noted weaknesses in their compliance with applicable professional standards, legal and regulatory requirements.*

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## STEP 03 Remedial Action Plan Required

- Where it is determined that the audit firm has some significant weaknesses which were pervasive in complying with applicable professional standards, legal and regulatory requirements.
- The work performed and evidence obtained thereon were inadequate and/or inappropriate and the basis needed to form the opinions expressed on those engagements was not adequately supported.

***Type 3** requires audit firms to prepare a remedial action plan (RAP). Subsequently, the audit firms will be subject to monitoring reviews on the implementation of the approved RAP within a specific time period, as prescribed in the MIA By-Laws.*

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## STEP 04 Unsatisfactory

- A situation where an audit firm has committed an offence or a breach against the laws and regulations of the country and MIA's regulations or the basis needed to form the opinions expressed on the engagement reviewed was not supported for reasons as stipulated in the MIA By-Laws.

***Type 4** will result in a complaint being lodged with the Registrar for the purpose of investigation.*

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***Note:- Since the last PR framework was reviewed and implemented in July 2017, a subsequent review of the framework is due every 5 years. The Council had on 29May 2023 approved the proposed review of the PR framework which would come into effect on 1 January 2024. This new framework will allocate a 24-month timeline between the first review and the subsequent review for firms to put up their annual remedial action plan and engagement of peer review before being subjected to a subsequent review.***

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## 4.0 Comparison between MIA as a statutory body vs other professional accounting bodies (e.g: ACCA, CPA Australia, AICPA-CIMA)

Members are advised not to be confused by comparing MIA with other professional accounting bodies (e.g ACCA, CPA Australia, and AICPA-CIMA). MIA is not a membership body per se like any other professional bodies. Our primary mandate is to regulate and develop the profession as per the Accountants Act 1967.

MIA is the national accountancy body and a statutory body that operates under the purview of **the Ministry of Finance** through the Accountant General's Department. MIA is the only accountancy body empowered by law to regulate the accountancy profession in Malaysia, thus making MIA membership mandatory for those holding themselves out or practising as an accountant in the country.

Thus, MIA is distinct compared to other professional accounting bodies, and each serves different objectives and purposes. While MIA also develops and supports its members, the regulatory function of MIA to monitor and regulate the practice of the accountancy profession is to ensure performance quality consistent with global standards and best practices and ultimately enhance the participation of the profession in serving the national economy and public interest. Professional bodies, on the other hand, exist to serve the interest of its members. While they may take on an oversight role of the profession, only MIA has the legislative authority to govern the profession.

We wish to reiterate that in Malaysia, there are only three regulators that can regulate the audit profession, which are MIA, AOB and SSM.  AOB is responsible for conducting quality assurance reviews of audit firms that are registered with AOB and audit PIEs under Part IIIA of the Securities Commission Act 1993 (SCA 1993). Although AOB is entrusted to regulate auditors of public interest entities (PIEs), MIA is still empowered to carry out a practice review on any audit firm (be it an AOB-registered firm) when the need arises.  SSM too, through its Corporate Accounts Monitoring Section, is primarily responsible for registration of audit firms, monitoring of changes in audit firms and approved company auditors, and monitoring the resignation and removal of auditors.

In other countries, the national regulatory authority that is similar to MIA is the Financial Reporting Council (FRC) in UK, Accounting and Corporate Regulatory Authority (ACRA) in Singapore, Australian Securities and Investments Commission (ASIC) in Australia, the Indonesian Institute of Public Accountants in Indonesia, the Saudi Organisation for Chartered and Professional Accountants (SOCPA) in the Kingdom of Saudi Arabia and the Institute of Chartered Accountants India.

Any sanctions taken against any partners of firms will only be published after the final determination of the case at the Disciplinary Committee/ Disciplinary Appeal Board (DC/DAB) or the courts if there is an appeal.

# Dialogue with the Chairman of the MIA Ethics Standards Board

at-mia.my/2023/06/27/dialogue-with-the-new-chairman-of-the-ethics-standards-board
June 27, 2023

Dr Veerinderjeet Singh, the recently appointed Chairman of the Ethics Standards Board (ESB), has nearly 40 years of working experience – five years in the then Malaysian Inland Revenue Department, three years in a large international accounting firm to obtain his three-year experience requirement needed to become a member of the profession, eight years as a senior lecturer/Associate Professor at the University of Malaya, nine years as a partner in a large international accounting firm and 15 years managing his tax practice including serving as Executive Chairman of the professional services group (including the tax practice) listed in Singapore.

Dr. Veerinderjeet Singh

He then moved on to taking up the role of an Independent Director on the boards of a few public and listed corporations. In between, he also found the time to lead the MICPA and the MIA as President besides serving on the councils and various committees of both professional bodies. All these roles certainly inculcated a good grounding in ethics and ethical behaviour in the various sectors.

He had decided during his secondary education to be an accountant and in his undergraduate years, he decided to specialise in the field of taxation. He then graduated with a Bachelor's in Accountancy (Hons) degree from the University of Malaya and a PhD in Accountancy from University Putra Malaysia. He also completed the professional examinations of the MICPA soon after graduating from University of Malaya.

Having been in various leadership roles where he saw a diversity in ethical approaches and how organisations handle ethical dilemmas, he felt it was an opportune time to get involved in the Ethics Standards Board and push ethics in the accountancy profession forward in a meaningful and effective manner.

He keeps in touch with tax policy developments around the world and continues to lobby for tax reforms in the Malaysian tax system. He enjoys watching movies and comedy shows in his free time.

Below are excerpts from an interview with Dr. Veerinderjeet:

**What do you consider to be the highlights of your career and experience that would bode well in the carrying out of your role as the new Chair of the Ethics Standards Board (ESB)?**

My experience has given me lots of exposure to ethical issues and dilemmas whether as a practitioner or a board member or as an individual. Serving on the Councils of MIA and MICPA provides me with a broad overview of areas where accountants face various issues including complying with the ethics guidelines and code of conduct. That experience will assist me in my role on the Ethics Standards Board in terms of working with the members in charting the way forward and undertaking suitable initiatives to continue to shine the light brightly on ETHICS and the need to walk the talk.

**One of MIA's strategic objectives is to nurture the professional values and ethics of members to uphold a strong accountancy profession. What is the vision and the direction of the ESB in realising this strategic objective?**

The ESB has been around for quite some time but apparently still does not feature prominently to MIA members. The ESB must engage members more often and speak up louder on issues of ethical challenges to the public at large. We have to continue to play our role better. As the previous Chair has stated before, ethics is an applied philosophy. Thus, the ESB needs to advocate the profession's ethical values and demonstrate their application. In my mind, whatever is said and done must be done with good old common sense.

We plan to have another review of our ESB Terms of Reference soon and discuss the initiatives that the ESB should be driving and focusing on given the current state of the profession and the economy. We welcome and hope to garner more varied participation from other fellow professionals and institutions. This will allow greater input from a wider group of stakeholders and exchange of viewpoints.

**How can ethics be inculcated and nurtured in accountancy professionals not only at work but also in every aspect of life?**

We have to believe that ethics cannot be codified in totality. Accountants are accountable and this behaviour cannot be left to a set of codes/rules or by-laws alone. To be respected, trust must be earned and to do so one must be trustworthy first. As such, the education system, one's upbringing and the environment all play a crucial role in moulding one's character, values and beliefs.

Students and staff should be nurtured properly. We need to place greater emphasis on ethics in schools, universities and the workplace. We must spend adequate time with the students and the staff and share our experiences. We must guide them on ethical precepts or practices that we have observed during our professional duties.

**We hear about ethical dilemmas being encountered at the workplace. How can they be addressed? Please also share any practical experience that you may have and tips or pitfalls to avoid.**

Any dilemma should be dealt with in strict confidence and with due process diligently observed. We must differentiate issues accordingly. At times they may be procedural, legal, or financial concerns and not necessarily ethical concerns. The prevalent rules should be allowed to function. We must trust the checks and balances that exist and change them if they are not working effectively. My experience on the Board of a listed GLC has also shown that we must manage the grapevine or office gossip by adhering to legal and formal ground rules.

Where there are material discrepancies, we must always investigate and substantiate these by obtaining independent opinions. We should avoid taking short cuts or cutting corners. More importantly, we must trust and stand by our fellow professionals as we know the high ethical standards that we live up to in our professional conduct. Keep senior management in the loop at the onset, not at the end, of any suspicious transactions. Keep the Board updated on relevant developments and do not wait to update them at the next scheduled meeting. Matters should be discussed and we should not try and sweep anything under the carpet.

**What would you consider to be the hallmarks of a good ethical corporate culture in an organisation?**

The tone from the top must be clearly communicated across the organisation. What the leaders say must be internalised by all and acted upon willingly. Mutual respect is key to ensure that a healthy and open conversation takes place at all levels of engagement by all stakeholders. Any organisation of high repute maintains a certain degree of professional standards by which accountability is an expected duty that binds everyone regardless of their respective roles. A good culture of ethical conduct will emerge over time once these factors – clear communication, responsible leadership and high professional standards – are clearly articulated and applied.

**What are some of the salient developments in the ethics code included in the MIA By-laws recently that members should take note of?**

Various revisions have been made and these aim to help reinforce the responsibility that professional accountants have to always act in the public interest. The Code and by extension the By-Laws, highlight that professional accountants are expected to comply with the spirit and not just the letter of the Code.

The revised Non-Assurance Services (NAS) provisions contain substantive revisions that clarify and address the circumstances in which firms and network firms may or may not provide a NAS to an audit and assurance client. The revised provisions expressly prohibit firms and network firms from providing certain types of NAS to their audit clients, especially when they are Public Interest Entities (PIE).

Highlights include enhanced provisions involving the identification and evaluation of self-review threats that might be created by the provision of NAS to an audit client and provisions to strengthen and improve the quality of a firm's communication to those charged with governance (TCWG) on NAS-related matters especially for audit clients that are PIEs.

As for the revisions to the fee-related provisions of the Code, there is now a clear prohibition on firms allowing the audit fee to be influenced by the provision of services other than audit to the audit client. In the case of PIEs, there is a requirement to cease to act as auditor if fee dependency on the audit client continues beyond a specified period. Akin to the NAS provisions, there are increased requirements to communicate fee-related information to TCWG to assist them in their judgments about auditor independence.

**The ESB recently responded to the IESBA's Exposure Draft, *Proposed Revisions to the Code Addressing Tax Planning and Related Services*. Why are the proposed revisions important? What would you consider to be some of the key comments raised to the IESBA on this Exposure Draft?**

Notable global events involving tax avoidance have come to light in recent years. As these have significant public interest implications, global bodies have also become increasingly focused on transparency and better disclosure of tax practices. Considering these revelations and in the interest of maintaining the relevance and robustness of the Code, the International Ethics Standards Board for Accountants (IESBA) made the decision to develop a principles-based framework to guide the ethical conduct of professional accountants when providing tax planning and related services.

When the ESB formulated its response to the IESBA's exposure draft on this topic, we generally supported the proposed revisions to guide the professional accountants involved in tax planning and related services. However, in areas such as "Disagreement with Management", the ESB also urged the IESBA to consider if the actions proposed were practical for the professional accountant by highlighting potential scenarios. Overall, the ESB also requested further clarity or guidance on the drafted standards in addressing certain pertinent situations to aid consistent application among the professional accountants.

**Given that *sustainability* is a hot topic these days and there is demand for a professional-agnostic code of ethics in dealing with sustainability disclosures, do you consider the international code of ethics for accountants to be well-poised to be established as an appropriate and accepted baseline?**

With the heightened demand for organisations to report on ESG/sustainability initiatives and performance, it is a matter of time that the same rigour by which financial statements are prepared and audited be required to be applied to such valuable other information contained in annual reports. A global baseline of ethical standards for assurance providers as well as preparers would be imperative to uphold integrity, avoid conflicts of interest, enhance accuracy and reliability and ensure a level playing field. These factors would in turn, promote and engender stakeholder trust in sustainability reporting particularly when greenwashing is rising as a topic of discussion. The global reach and efficacy of the international ethics standards (the Code) as issued by the IESBA as well as the fact that the Code having stood the test of time over many years of development, use and enforcement should be compelling reasons for using the Code as a baseline for all professionals engaged in sustainability reporting. However, to make this happen, strong regulatory backing and reforms would be imperative and urgent.

# Elevating Public Sector Financial Management

[at-mia.my/2023/06/30/elevating-public-sector-financial-management](at-mia.my/2023/06/30/elevating-public-sector-financial-management)
June 30, 2023

*By MIA Sustainability, Digital Economy and Reporting Team*

The Malaysian accountancy profession enjoys excellent representation at global levels, thanks to strong stakeholder engagement and relationships.

Advocating for Malaysia at the global level is Deputy Accountant General of Malaysia Nor Yati Ahmad, who became a member of the International Public Sector Accounting Standard Board (IPSASB) in January 2023. She was nominated by the Accountant General's Department of Malaysia under the Ministry of Finance, Malaysia.


Nor Yati Ahmad

Her wealth of experience as a senior accountant at both the Federal and State Government levels equip her well for this global role. Prior to her appointment as Deputy Accountant General of Malaysia recently, she held various positions within the Accountant General's Department of Malaysia, including Director in the Central and Agency Operations Division. This division is responsible for coordinating and preparing the Federal Government's Financial Statements, which consists of 26 ministries using an accounting system called iGFMAS (Integrated Government Financial and Management Accounting System).

Nor Yati also served as the Director in the Accrual Accounting Implementation Team (the Team) where she led the implementation of accrual accounting in the Federal Government, State Government, and other public sector entities. "The primary objective of the Team is to develop the Malaysian Public Sector Accounting Standards (MPSAS) to be applied by all public sector entities in Malaysia. This process involved adapting international standards from the International Public Sector Accounting Standard (IPSAS) to suit the local jurisdiction. With the support of the AGD and the Ministry of Finance, MPSAS has been able to be adopted by public sector entities since 2016 with ongoing research and post-implementation reviews ensuring high-quality financial statement reports," explained Nor Yati recently in an exclusive interview with the Malaysian Institute of Accountants (MIA) e-AT.

> "However, the presentation and the preparation of the Financial Statements of the Federal and State Governments in the Parliament and the respective state Legislative Assembly are under the cash basis of accounting until the proposed amendment to the Financial Procedures Act 1957 is approved in Parliament," Nor Yati clarified.

Nor Yati also touched on the challenges and purpose of public sector accounting. "One of the key challenges in public sector accounting lies in balancing the delivery of public services to the people while effectively managing resources. Unlike the profit-oriented private sector, the public sector operates with a different objective. Public sectors are entrusted to deliver a wide range of public services and manage the public sector efficiently and cost effectively. In cash-modified accounting, certain information regarding assets and liabilities is not accounted for due to the basis of accounting used. Moving towards accrual accounting requires accountants to be proficient in incorporating accrual principles into their daily tasks, such as preparing financial statements and conducting analyses."

Nor Yati expressed the aspiration that their experiences and contributions "will help elevate public sector accountants to a higher level, enabling them to efficiently deliver services and manage resources for the betterment of society".

In addition to her many roles, Nor Yati is actively involved in various accounting committees, including the Public Sector Accounting Committee of Malaysian Institute of Accountants (MIA) and the Islamic Accounting Standard Research and Drafting Committee for Waqaf, Zakat and Baitulmal. Additionally, she serves as a board member in a Government-Linked Companies (GLC).

Below, Nor Yati talks at length about the Malaysia's adoption of accrual accounting, her role at IPSASB, IPSASB's accomplishments and critically, the role of public sector accountants in driving sustainability and sustainable nation building.

## Why did Malaysia decided to adopt accrual accounting? What are the benefits of the adoption to Malaysia?

Adoption of accrual-based accounting is one of the steps identified under the implementation of the Discipline and Fiscal Reform Policy in the New Economic Model (NEM) in 2010. The NEM contains 8 Strategic Reform Initiatives, aimed at transforming Malaysia into a high-income, sustainable, and inclusive economy. The implementation of accrual accounting is seen as crucial in generating comprehensive financial reporting that provides a more comprehensive view of public sector financial sustainability.

Malaysia, being a developing country facing uncertainty in the global economy, is under increasing pressure to ensure agile, competitive, and sustainable financial management, particularly in asset and liability management. Accrual-based accounting helps mitigate risks associated with limited information that can impact asset and liability management, such as exposure to increased contingent liabilities. By utilising accrual accounting, the management of public money becomes more transparent and effective through the analysis of fiscal aggregates, considering various perspectives to provide a true reflection of government operations. It also provides additional information that offers a broader understanding of public sector financial sustainability, including financial position and analysis of actual activities with significant changes over time. This comprehensive information enables decision-makers to assess long-term fiscal sustainability and plan financial policies more effectively.

Although accrual accounting has not yet been officially implemented, Malaysia has already experienced positive impacts by adopting accrual-based practices. Ministries have gained insights into recognising and recording assets, liabilities, accounts receivable, and accounts payable on an accrual basis. Gathering data on assets and liabilities to present a clearer government financial position has allowed ministries to identify under-utilised assets and dispose of unused assets. The detailed information provided by accrual accounting helps ministries better utilise financial resources, particularly in asset and liability management, and aids in decision-making processes related to asset acquisition

## Based on your involvement in the Accrual Accounting Implementation team since 2011, what are the challenges faced in implementing accrual accounting in Malaysia? How did you address the challenges?

The main challenge in implementing accrual accounting in Malaysia is to convince and engage accountants, civil servants involved in financial management, and other stakeholders about the benefits of this approach. To address this challenge, numerous studies, awareness campaigns and briefings have been conducted, highlighting a comparison with other countries that have successfully implemented accrual accounting. It is essential for accountants at the federal and state government levels to understand the impact of accrual accounting on their work processes and the recognition and measurement of various items, transitioning from modified cash practices to accrual-based accounting practices. Another challenge is to ensure the financial statement prepared are of high quality, consistent and comply with the accounting standards. To address this challenge, a governance structure has been established to develop an implementation strategy, monitor the process, and issue public sector accounting standards (MPSAS) and guidelines. Additionally, efforts have been made to develop a comprehensive accounting system and a change management strategy.

However, for other public sector entities that have already adopted accrual accounting, the challenge is relatively less compared to Federal and State government. This is because these entities only need to apply MPSAS, which allows them to better represent their financial statement to reflect the unique nature of public sector transactions and provide a true view of the entity as a public sector entity.

## Why did you get involved in IPSASB?

By getting involved in IPSASB, my contribution might help them to develop International Public Sector Accounting Standards (IPSAS) by providing our views and insights from the Malaysian context. It also gives me the opportunity to exchange views with other IPSASB members in implementing IPSAS in their jurisdictions. Further, it will give us first-hand information on what, why and how the development of IPSAS (is done) in such a way. This is beneficial to us in developing our MPSAS (which is based on IPSAS) and assists public sector financial statements preparers prepare financial statements without compromising the quality of financial reporting. Thus, it assists the decision-maker in sound decision making by providing them with high quality financial reporting.

## As a member of the IPSASB, how does the work of the IPSASB contributes to public financial management?

The IPSASB works to strengthen public financial management globally through developing and maintaining accrual-based International Public Sector Accounting Standards (IPSAS) and other high-quality financial reporting guidance for use by Governments and other public sector entities. It also raises awareness of IPSAS and the benefits of accrual adoption[1].

## Could you share some of the significant works of IPSASB in the recent years?

The IPSASB has made several significant developments in its standard-setting and implementation projects by issuing the following:

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|---|---|---|---|
| **IPSAS 44**, *Non-current Assets Held for Sale and Discontinued Operations* specifies the accounting for assets held for sale and the presentation and disclosure of discontinued operations. | **IPSAS 45**, Property, Plant and Equipment replaces IPSAS 17, *Property, Plant and Equipment.* Itintroduces current operational value as a measurement basis within the updated current value model for assets within its scope. The standard also identifies the characteristics of heritage and infrastructure assets and provides new guidance on their recognition and measurement. | **IPSAS 46**, *Measurement* which consolidates measurement guidance into a single standard, introducing a public sector-specific current value measurement basis for assets held for operational capacity, as well as including generic guidance on fair value. | **Approved Project brief** of Sustainability Reporting – Climate-related Disclosure for the public sector and develop the standard. |

All the above can be accessed through the IPSASB webpage.

## What is the role of the IPSASB in advancing public sector sustainability reporting?

Respondents to the IPSASB's Consultation Paper on Advancing Public Sector Sustainability Reporting agreed that the public sector urgently needs its own sustainability reporting standards and that the IPSASB, with its 25 years of standard setting experience, should lead the development. To enhance transparency, accountability, and comparability in addressing climate change and other sustainability challenges, the IPSASB is working towards developing public-specific sustainability reporting standards. The IPSASB has decided to proceed with the development of a Climate-Related Disclosures standard and has published a project brief outlining this important initiative[2].

The IPSASB will establish a Climate-related Topic Working Group which will provide specialised expertise and advice to support the development and implementation of the standard. Additionally, a Sustainability Reference Group will be formed to provide guidance on the overall sustainability reporting standards development program.

## What is the current stage of public sector sustainability reporting in Malaysia?

Malaysia has aligned and integrated Sustainable Development Goals (SDGs) into the 12th Malaysia Plan and is linking the Malaysia Plan to ministries, programs, and activities. In terms of costing the SDGs, Malaysia has adopted a practical approach by integrating both public and private flows into annual and medium-term plans. The costing of SDGs has been incorporated into the detailed costing of SDG baselines, providing a comprehensive understanding of the financial requirements.

The government of Malaysia has taken a more catalytic role in accelerating the progress of SDGs. The Ministry of Natural Resources, Environment and Climate Change (NRECC) is leading the efforts towards Sustainable Malaysia 2030 where it issued a roadmap in 2020 titled Environmental Sustainability in Malaysia 2020-2030 outlining 30 initiatives.

In support of the roadmap, the AGD has undertaken a study of the Integrated Reporting (IR) Framework that identifies disclosures related to the creation and preservation of value that benefits all stakeholders. The study also aims to create a reporting scope that reflects increased accountability, stewardship and trust to relevant stakeholders. It also emphasizes the use of technology to improve information flow and transparency in business operations. Based on this study, a guideline has been issued as a reference for the preparation of IR at the ministry-level.

## What are the roles of public sector accountants in sustainability?

Sustainability reporting is crucial for public sector entities in decision-making and future planning on ESG issues. Public sector accountants undoubtedly will lead sustainability reporting as the report will address the sustainability efforts and performance of the entity by providing financial and non-financial data and information. Besides, they also will give advice on sustainability reporting and its requirements. They need to analyse costs and impacts of related ESG projects and help their entity's decision-making process more efficiently due to the transparency relationship between financial information including the sustainability efforts and performance information. Thus, this will help the entities' decision-making processes become more efficient that will influence long-term and short-term management strategy, policy and business plan, and at the same time reduce risk by implementing internal controls that will lead to reduced waste and significant cost saving. Accountants are also expected to provide auditing and assurance to public sector entities that will ensure reliable and transparent sustainability reporting for informed decision-making and ESG planning.

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[1] *International Public Sector Accounting Standards Board (IPSASB). (2023, June 26). About IPSASB. https://www.ipsasb.org/about-ipsasb*

[2] *"IPSASB Begins Development of Climate-Related Disclosures Standard for the Public Sector", 14 June 2023; https://www.ipsasb.org/news-events/2023-06/ipsasb-begins-development-climate-related-disclosures-standard-public-sector*

# Enhancing Quality Assessment Programme for SMPs

at **at-mia.my**/2023/05/09/enhancing-quality-assessment-programme-for-smps
May 9, 2023

*By MIA SMP Department*

First introduced in 2016 as one of the initiatives under the SMP Roadmap 2015-2020, Quality Assessment Programme (QAP) is an initiative of the MIA's Small and Medium Practices Committee, in collaboration with The Malaysian Institute of Certified Public Accountants (MICPA), to promote continuous improvement in audit quality in Malaysia. QAP assists Small and Medium Practices (SMPs) in assessing compliance with the applicable auditing standards and MIA By-laws, in relation to audit engagements on financial statements prepared in accordance with the applicable approved accounting standards and the Companies Act 2016.

It has been more than 6 years since the inception of QAP, whereby the MIA-MICPA QAP agreement was signed on 25 October 2016 under certain regulatory environment. As part of our commitment to continuous improvement, several changes have been carried out in ensuring that QAP will remain relevant. Below are the enhancements that have been made as well as those in the pipeline.

## Change in the report format submitted to MIA

Since the commencement of the QAP until March 2022, MICPA had been forwarding the final report issued after the conclusion of a QAP in which an audit firm participates to the Small and Medium Practices (SMP) Department of MIA, in order for MIA to monitor the effectiveness of the QAP. The final reports which entailed the findings of the review and remediation action plan could only be accessed by the staff of the SMP Department. The overall findings from the final reports would then be compiled and shared as appropriate in an e-AT article such as "Quality Assessment Programme: Common Findings of the Firm-level and Engagement-level Review" issued in June 2022, which covered the common findings garnered and observed from the completed reviews since the introduction of the QAP until May 2022.

Even though there is restricted access to the final reports, some audit firms considered the matter of confidentiality as a deterrent to participating in the QAP. Hence, beginning April 2022, it has been agreed that MICPA will only forward the summarised report to MIA, as a mechanism for MIA to assess the effectiveness of the QAP and at the same time to provide comfort to participating firms on the confidentiality of information, especially since this is a voluntary exercise.

In comparison with the detailed final reports, the summarised report will only contain the key findings of the functional review of ISQC 1 and the detailed review of the audit engagement without specific or contextualised information about the key findings.

## Capping of maximum fee for participation in the QAP

Taking cognisance that practitioners are still navigating away from the aftermath of the pandemic and to enable more audit firms to participate in the QAP, the maximum fee for participation has now been reduced from RM10,000 to RM6,000 and will be valid until 30 June 2024. This update was conveyed through a notice to all audit firms dated 18 August 2022.

Audit firms are urged to seize the opportunity to participate in the QAP at a reduced fee while this rate is still on offer.

(Note: *The maximum fee excludes out-of-pocket disbursements and Sales and Services Tax*)

# Quality Improvement Period

In a notice to all audit firms on 18 August 2022, the Institute announced that audit firms that have participated in the QAP will be given time for quality improvement and will not be selected for MIA Practice Review at least within the 12 months after the completion of the QAP. The completion date of the QAP will be the date of the final report issued to participating firms. This is to provide participating audit firms with a reasonable period for them to execute the remediation action plan as recommended in their QAP final report.

Subsequently, the improvement period was revisited to allow for a longer improvement period and from April 2023 onwards, the improvement period has been increased to 24 months after the completion of the QAP, provided the whole process (starting from the audit firm's enrolment in the QAP Programme) does not exceed 36 months.

(Note: *Under normal circumstances, QAP participating firms will not be selected for practice review by MIA during the 24-month improvement period, except for firms referred by other regulators for inspection/investigation/disciplinary action* or arising from a risk-based assessment.)

# Change from functional review of ISQC 1 to ISQM1 (In the pipeline)

As of 15 December 2022, ISQM 1 replaced ISQC 1. The QAP will need to be tailored for ISQM 1 moving forward and hence, requires a change in the review programme. MICPA, as the main coordinator of the QAP, is presently revamping the functional review methodology.

Will there be a revision of fees? Yes, there will be an additional RM500 increase in the total maximum fee due to the expected increase in man hours required to review the ISQM 1 due to additional elements if compared with ISQC 1.

The functional review of ISQM 1 is expected to be rolled out in Quarter 4 of 2023. MIA will inform audit firms when the arrangement has been finalised. Do watch out for email blasts from MIA and also updates through the social media, especially the Telegram channel for the SMPs (MIA SMPs Channel).

While several audit firms have already benefitted from QAP participation, the Institute would exhort greater participation by audit firms in the QAP to leverage on the opportunity to improve audit quality. SMPs, especially new audit firms or firms that have yet to undergo practice review, should undertake pro-active steps to identify areas for improvement while setting the right progressive tone for the firms by participating in the QAP.

MIA will continue to pursue initiatives to support audit firms in their quest for continuous improvement in audit quality. For suggestions or feedback on QAP, please submit your ideas or comments through email at smp@mia.org.my.

**Interested to learn more about QAP?**

Please click here for more information about QAP.

Testimonials from participating firms, detailed processes, charges and the comparison between practice review and QAP can be found in the following e-AT articles:

- Thumbs up for QAP
- Everything you need to know about QAP
- Quality Assessment Programme: Common Findings of the Firm-level and Engagement-level Review

**Interested to participate in QAP?**

Interested firms are required to complete the Practice Profile Information Questionnaire by clicking here and forwarding the completed questionnaire to the SMP Department at smp@mia.org.my. The questionnaire will enable the QAP reviewer(s) to understand your practice better.

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For further enquiries on the QAP, please contact MIA SMP Department at smp@mia.org.my .

# Ethical Leadership in a Digital Era

at [at-mia.my/2023/06/28/ethical-leadership-in-a-digital-era](https://at-mia.my/2023/06/28/ethical-leadership-in-a-digital-era)
June 28, 2023

*By MIA Sustainability, Digital Economy and Reporting Team & Nazatul Izma*

Ethics is increasingly taking a front-seat as the profession reflects on what good governance looks like for technologically enabled accountants who live and work in the digital economy.

This was the main theme addressed in the MIA Digital Month 2023 panel on ***Ethical Leadership in a Digital Era*** moderated by the Chair of MIA Digital Technology Implementation Committee (DTIC) Lim Fen Nee recently. The panel also featured Justin Ong, Executive Director, Deloitte Malaysia Risk Advisory; Ravindran Navaratnam, Former chair and current member of MIA Ethics Standards Board (ESB); and Josephine Phan, member of the MIA DTIC.

The following are some key takeaways from the panel session.

### Inculcating a culture of ethics is crucial

According to Lim, ethical practice is fundamental because it contributes to public trust and confidence in the profession. It is the accountant's responsibility, added Navaratnam i.e. to practise ethics when using technology or otherwise.

Some people may be born more ethical than others. However, it is important to have an ecosystem that encourages ethical practice at all times and that creates ethical professionals who strengthen that ecosystem.

Ethical leadership is something that can and should be practiced by everyone, even when it is not rewarded. "Ethical leadership is not just for leaders, but for all users of technology," stressed Phan. "Build digital trust with your stakeholders. Basically, it's about adopting technology with accountability and responsibility beyond compliance."

> "Your ethical standards, your professional standards, is what you do when no one is looking," added Navaratnam. "Ethics are not philosophy. It's really asking what are the actions that you can implement in your day-to-day routine, your work culture, your corporate culture, that will sustain, preserve, and enhance ethical standards?"

One way to promote this ecosystem is by spelling out what ethical conduct means within an organisation. This includes promoting certain principles of ethical conduct, such as accountability, or encouraging accountants to proactively speak up and report any wrongdoings.

Organisations as well as public practitioners are advised to refer to the MIA By-Laws (On Professional Ethics, Conduct and Practice) and relevant guidance to flesh out a framework for ethics. Lim emphasised that the MIA By-Laws promotes five tenets of professionalism — namely, integrity, objectivity, professional competence/due care, confidentiality and professional behaviour. As the regulator of the profession, MIA will also be releasing a non-authoritative guidance on ethical conduct for accountants in public practice on using technology.

### It is critical to consistently enforce ethical conduct

Weak enforcement and neglect of ethical conduct contribute to ethical risks. “We all have a SOP (standard operating procedure) in place, but we don’t always enforce it,” noted Ong.

How can enforcement be enhanced? Organisations should harness carrots and sticks effectively to ensure that there is no breach of the ethical floor and that employees hold themselves to the highest ethical standards possible. “There is no upward line [or ethical ceiling] to be breached,” said Navaratnam.

Education and raising awareness play a tremendous role in instilling ethics. As such, MIA strongly advocates for ethics in its professional development programmes so that members are informed of the right thing to do and the reasons for strictly upholding ethics. Accountants must understand the implications of ethical breaches, explained Phan, because “we do the right thing when we know *why* we are doing it.”

### Be aware of the vast range of ethical digital risks

As technologies evolve, accountants need to be sensitive to the emerging risks. This includes countering potential bias in artificial intelligence, as well as conducting due diligence to determine that data or any other technological output used comes from credible and ethical sources.

### Prepare sufficient financing and facilitate change management to promote ethical usage of technology

Accountants should also harness their financing expertise to allocate sufficient budgets for funding secure data systems, upskilling staff and creating an ethical digital culture. This is more critical than ever post-COVID; not only there is greater adoption of technology, according to Ong, but there is higher risk of private data being vulnerable as more employees are working from home.

Proper change management also needs to be in place to clarify what technology is being deployed in the organisation, what roles and processes have changed as a result, and what digital training is required going forward.

### Commit to continuous learning

Accountants have a steep but necessary learning curve ahead of them to remain relevant. As such, MIA places a keen emphasis on digital adoption and education to upskill members to be future-fit for the digital economy. Upskilling and competency building will be especially critical to ensure that accountants are conversant with the ethical and systemic risks surrounding digital transformation and the impacts on good governance.

### Embrace Strategic Collaboration

Granted, not everyone will be able to become experts in all technologies and the risks it poses, especially not overnight. “The key thing is working closely in collaboration with internal stakeholders and talking to subject matter experts within the organisation if you have the expertise to do that, or you may need to reach out,” advised Phan. This is synergistic with MIA’s advocacy for strategic collaboration in key areas, particularly digital adaptation for the future relevance for the profession.

# Facilitating SDGs with Islamic Finance (Part 3) Mobilising Islamic Fintech in Malaysia

**at-mia.my**/2023/05/05/facilitating-sdgs-with-islamic-finance-part-3-mobilising-islamic-fintech-in-malaysia
May 5, 2023

*By Zulfa Abdul Rahman*

In its "call to action" published in August 2022, IFAC asked professional accountancy organisations (PAOs) and stakeholders to identify how Islamic financial instruments have been used to advance Sustainable Development Goals (SDGs). Malaysia, one of the pioneers of Islamic finance, is the first case study in this series reporting on Government, regulatory and industry efforts to support the SDGs with Islamic finance principles.

The first part of the Malaysian case study published on 7 September 2022 focused on *sukuk*, which provides the means to deliver more infrastructure investment to emerging economies.

The second part of the Malaysian case study looked at the concept and purpose of Value-Based Intermediation (VBI) and how VBI advances the attainment of the SDGs.

This third part of the Malaysian case study highlights the Islamic Fintech landscape in Malaysia and the potential benefits and challenges faced in mobilising Islamic Fintech to achieve SDG goals.

## Islamic Fintech in Malaysia – a Panacea for Financial Inclusion?

Financial inclusion is key to achieving the United Nations' 17 SDGs, in particular, helping to reduce poverty (SDG1); enabling investment and cost-effective services in the core sectors of agriculture, health, education, and energy (SDG2, SDG3, SDG4 & SDG7); diminishing gender inequality (SDG5); and spurring broader economic growth (SDG8 & SDG9).

Yet, many people globally remain unbanked and underbanked. One reason lies in religious and ethical concerns, such as the Islamic faith's injunction against usury and interest. According to the 2020 World Bank report on Leveraging Islamic Fintech to Improve Financial Inclusion, up to 50% of the world's unbanked 1.7 billion people and more than 200 million potential micro, small, and medium enterprises (MSMEs) are concentrated in Muslim-populated developing countries.

The answer to this could be Islamic Fintech, which merges syariah-compliant finance and technology to support financial inclusion. Islamic Fintech services simplify and facilitate access to financial services—such as *takaful*, or Islamic insurance, payment systems, and banking—for hard-to-reach populations at more affordable costs.

Furthermore, championing Islamic Fintech would fuel aspirations of financial inclusion and global sustainability. Islamic finance as a form of ethical finance is already synergistic with environmental, social and governance (ESG) frameworks given their shared emphasis on positive and sustainable development. Islamic finance services that are imbued with the principles of *maqasid al-Shariah* (i.e. Shariah's intended outcomes) and delivered through digital channels could potentially be a panacea for financial inclusion.

## Malaysia Well-Placed to Lead in Islamic Fintech

While several countries are competing for global leadership in the Islamic Fintech space, Malaysia has several strengths, notably in the context of infrastructure and regulation:

**Malaysia has ranked first in the Global Islamic Fintech (GIFT) Index** since the index was first launched in 2021, surpassing 64 other countries in talent, regulation, infrastructure, Islamic Fintech market and ecosystem, and capital.

Almost 40% of respondents polled in the 2021 IFN Fintech CEO & Founder Survey recognised **Malaysia as having the most conducive Islamic Fintech ecosystem in the world.** Key to this is hands-on stakeholder engagement from the Malaysia Digital Economy Corporation (MDEC), the principal government agency overseeing the country's digital economic transformation.

The regulatory infrastructure overseen by Bank Negara Malaysia (BNM) and the Securities Commission Malaysia (SC) is consistently upgraded, **in line with the 2022-2026 Financial Sector Blueprint which articulates Malaysia's vision for Islamic fintech.** Recent initiatives by BNM include releasing a discussion paper on licensing digital Takaful operators and plans to amend its Innovation Green Lane this year to facilitate Fintechs. Currently, the Innovation Green Lane only fast-tracks market validation trials and financial solution approvals for Islamic Financial Institutions (IFIs) but not Islamic Fintechs unless partnered with IFIs.

**Malaysia's Islamic Fintech governance is underpinned by the concept of value-based intermediation,** which was pioneered by BNM and guides the overarching regulation of Islamic finance in the country to achieve social finance, holistic development and inclusion goals.

## Malaysia's Islamic Fintech Landscape

This facilitative ecosystem has seen the emergence of 48 *halal* Fintechs in various business sectors and at different stages of maturity. According to MDEC's 2022 Islamic Fintech Dialogue Report, these include:

| | | | | |
|---|---|---|---|---|
| TakaTech *(Islamic insurance)* **(6)** | Personal Finance Management **(2)** | Blockchain and Crypto-currencies **(3)** | Islamic Enablers **(2)** | Crowd-funding **(4)** |
| Payment, Remittance and Foreign Exchange **(10)** | Robo Advisers **(2)** | Trading and Investment **(7)** | Alternative Finance **(6)** | P2P Finance **(6)** |

*Halal* Fintechs which are already up and running include:

- Finterra, a developer of blockchain solutions for Islamic social finance such as charity (*sadaqah*), endowment (*waqf*), and alms (*zakat*);
- microLEAP, a P2P microfinancing platform partnering with SME Corp to disburse RM10 million in Shariah-compliant financing to SMEs;
- PayHalal, which offers Shariah-compliant Buy Now Pay Later (BNPL) in partnership with Atome;
- CapBay, a provider of Shariah-compliant supply chain financing solutions; and
- Ethis, an ethical investment and social finance platform which is collaborating with venture capital firm Gobi Partners to establish a USD20 million seed fund for investing into Shariah-compliant start-ups globally.

Attesting to the buoyant prospects of Islamic Fintech in Malaysia, 33% of Islamic Fintech companies globally are headquartered in Kuala Lumpur as of 2022 (according to Tan Sri Dr Mohd Daud Bakar, Chairman of the BNM and SC Shariah Advisory Council in his opening remarks at the Islamic Fintech Leaders Summit 2022) and BNM approved two Islamic digital banking licenses in 2022.

## Impediments to Growth

While the numbers appear laudable at first glance, the Islamic fintech sector still pales in comparison to its conventional counterpart.

According to Fintech News Malaysia, Islamic Fintech only accounted for a 5% share (or 16 out of 294 companies) of Malaysia's overall Fintech space in 2022. Even if there were 48 Islamic Fintechs as per MDEC's 2022 Islamic Fintech Dialogue Report, this means that Islamic Fintechs only comprise roughly 16% of Malaysia's total Fintech market.

What is impeding Islamic Fintech and digital banks from breaking out and scaling up, in spite of the enviable regulatory support? Talent scarcity and access to finance are among the main challenges cited by respondents in various market surveys and research reports on Islamic Fintech.

Talent scarcity does not just affect operations but also Shariah compliance for Fintechs, compared to traditional IFIs, because of their 'plug-and-play' models [Mufti Faraz Adam, Global Islamic Fintech Report 2021]. With core parts of their infrastructure outsourced to third-party vendors, Fintechs must ensure external as well as internal Shariah compliance across their business models. However, there is an acute shortage of professionals who are competent in the governance and assurance of both Shariah and technology.

Unsurprisingly, lack of financing has emerged as a key barrier to growth: 33% of respondents from the 2021 IFN Fintech CEO & Founder Survey named access to capital as the biggest hurdle to scaling up, followed by poor Islamic finance literacy and unsupportive regulations.

One reason for the lack of financing is that many angel investors, private equity firms, and venture capitalists are based in non-Muslim countries, where Islamic finance's minute footprint is off their radar. This lack of awareness is compounded by low literacy in Islamic finance. A limited understanding of Islamic finance's differences with conventional finance— and even prejudice against Islam— translates into investor hesitance when it comes to backing Islamic Fintech, even though there are clear synergies between sustainable development and Shariah-compliant Islamic finance.

While there is capital available in Muslim countries, with Malaysia holding an estimated $619.7 billion in Islamic finance assets for 2021 according to the 2022 State of the Islamic Global Economy Report, smaller Islamic Fintech companies face challenges in securing investment funding or strategic partnerships. In the Malaysian Digital Economic Corporation (MDEC) 2022 Islamic Fintech Dialogue Report, industry insiders revealed that Islamic banks and funds in Malaysia are uninterested in acquiring or funding these start-ups.

Worse still, stiff competition from financial incumbents with their own digital offerings and mobile platforms are crowding out start-ups. IFIs' reluctance to collaborate also stifles broader Fintech innovation, as start-ups are unable to experiment with new product offerings by tapping on the infrastructure, expertise and other resources of larger IFIs.

This reluctance poses a setback for financial inclusion and SDG goals. Most Islamic Fintech products globally focus on the alternative finance, payments, fundraising, and deposits & lending market segments that serve the underbanked and unbanked. Here in Southeast Asia with a regional Muslim population of more than 240 million, there are only six Islamic Fintechs geared towards insurance and social finance respectively, according to the 2022 Global Islamic Fintech Report.

## The Way Forward

Creditably, Malaysia has put in place key initiatives to help resolve the bottlenecks pinpointed by Islamic Fintechs. With regards to talent, the Fintech Booster capacity-building program introduced by BNM and MDEC enables Islamic Fintech companies to learn legal and compliance matters from Shariah advisory firms and consultants. The FIKRA Islamic Fintech Accelerator Programme, a joint initiative helmed by the SC and United Nations Capital Development Fund intends to: **one**, help SDG-aligned, innovative and sustainable Islamic Fintechs scale up and **two**, strengthen the talent pipeline by increasing awareness on career opportunities within the Islamic Fintech space.

With regards to financing, the establishment of Penjana Kapital which is a Government fund-matching scheme is key towards strengthening the funding ecosystem in Malaysia [MDEC CEO, Mahadhir Aziz, as quoted in the Malaysian Reserve's February 2023 article "Funding, talent poser in the making of unicorns". Other initiatives that could benefit Islamic Fintechs include the recent launch of the Employees Provident Fund's $600 Islamic Private Equity Fund and the RM60 million Shariah-compliant FICUS SEA Fund by Malaysia Venture Capital Management and Ficus Capital, which focuses on financing early-stage technology companies.

Nonetheless, these remain largely top-down government-driven initiatives. While government support is important to drive growth, it is equally crucial for the private sector to advocate for Islamic Fintech. For instance, boosting rates of Islamic Finance literacy among consumers and investors to improve adoption and usage of Fintech services, and encouraging collaboration versus competition between IFIs and Fintechs.

Critically, Islamic Fintechs also must do their part by strengthening their business models and value propositions to capture investor interest, attract strategic collaboration and broaden the appeal of their offerings.

By virtue of their tremendous potentials and backed by supportive government policies and infrastructure, Islamic Fintechs in Malaysia should be poised to be at the forefront of the social finance scene and also in the vanguard of the global movement for financial inclusion. Certainly, this is a space to watch.

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*Zulfa Adbul Rahman is the team lead for the Islamic Finance Unit in the Professional Practices and Technical Division at the Malaysian Institute of Accountants. She is also the secretariat to the MIA Islamic Finance Committee, which aims to promote Islamic finance through various initiatives, such as collaboration with relevant stakeholders and accountancy bodies. Some of her notable involvements include the World Congress of Accountants 2010 (where Islamic finance topics were first introduced at its platform), organizing the National Zakat Symposium, conducting the Islamic Finance Pupillage Programme, publishing the Accounting for Islamic Finance textbook, and various stakeholders' engagements though roundtable discussions. More recently, she worked on a collaboration with a local university to publish shariah audit reference materials. Previously, Zulfa was attached to a commercial bank where she worked in the Trade Finance Division for 8 years. Zulfa is a Chartered Accountant of MIA (C.A.) and Chartered Global Management Accountant (CGMA).*

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# Malaysia Tax Conference 2023: Collaborating for a Sustainable Tomorrow

[at-mia.my/2023/06/06/malaysia-tax-conference-2023-collaborating-for-a-sustainable-tomorrow](at-mia.my/2023/06/06/malaysia-tax-conference-2023-collaborating-for-a-sustainable-tomorrow)
June 6, 2023

*By Mohd Faiz Othman*

As a regulator and developer of the accountancy profession, the Malaysian Institute of Accountants (MIA) strongly advocates for tax governance and ESG matters to enable sustainable business and nation building.

As tax governance is critical to ensuring fiscal health for national development, MIA is committed to upskilling accountants and tax professionals on the latest tax developments to remain relevant and future-proof.

One of the leading events on the national tax CPD calendar is the annual Malaysian Tax Conference 2023, jointly organised by the MIA and the Malaysia Association of Tax Accountants (M.A.T.A). For 2023, this popular Conference returns in a physical format and will run over two days from ***26 – 27 June 2023 at the Connexion Conference & Event Centre @ Nexus, Bangsar South, Kuala Lumpur***.

Focusing on the theme ***'Collaborating for a Sustainable Tomorrow'***, the conference brings together expert speakers from the Ministry of Finance (MoF), Inland Revenue Board of Malaysia, World Bank, industries and leading accountancy firms to share their insights into the latest developments and impacts on tax. Delegates can look forward to the following Conference highlights:


- Discussions on the **strategic role of taxation** in long term economic growth and how best to implement a new and innovative tax regime in Malaysia for socio-economic resilience.
- An overview and comparison of **capital gains tax** laws in ASEAN and developed countries, along with insights into Malaysia's potential capital gains tax regime and how to plan strategically for the change.
- Discussions on the recent issues and controversies, procedures and mechanisms relevant to **tax disputes, and mechanisms for resolution**, through either settlement or formal litigation.
- An informative session on the **Corporate Tax Governance Framework**, covering the scope, benefits, process, and timeline of implementation.
- Updates on selected **key corporate tax cases and significant decisions** relevant to taxpayers including recent Court of Appeal and High Court cases.
- Knowledge sharing on **Transforming the Tax function through Technology and Automation**, focusing on the transformation of tax administration management and the intended implementation of e-Invoicing in stages.

- Knowledge sharing on **Tax and ESG**, focusing on the implementation and implications of carbon taxes to manage greenhouse gas emissions and green tax incentives to encourage sustainable practices.

Do join this important annual Conference to explore the key emerging tax issues as well as the critical role of tax incentives in driving sustainability, in order to be future-fit and future-relevant.

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*To find out more and register for the Malaysian Tax Conference 2023, please click* here.

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***Note:*** *CPD points gained from attending the Malaysian Tax Conference 2023 qualifies for the purposes of application or renewal of tax agent licence under Subsection 153(3), Income Tax Act 1967.*

# MIA Digital Economy and Reporting Insights (January – March 2023)

at-mia.my/2023/05/15/mia-digital-economy-and-reporting-insights-january-march-2023
May 15, 2023

The MIA Digital Economy and Reporting Insights provides quarterly updates on the areas of digital economy, tax and reporting. The Insight highlights contents and initiatives that are of high value to members.

## MIA Digital Month 2023

Back again by popular demand, MIA Digital Month 2023 (MDM 2023) brought a dynamic month-long digitalisation convention geared to enabling digital technology adoption by the accounting profession in Malaysia. Centred around good governance as the foundation of the Environmental, Social and Governance (ESG) agenda, MDM 2023 championed ethical leadership in the digital economy, shared success stories on digital technology adoption, and advised delegates on managing cybersecurity risks and acquiring digital skills required for relevance, resilience, and future sustainability. MDM showcased a weekly complimentary webinar for four weeks running from 16 February 2023 to 8 March 2023. The MDM ended with our grand finale – the MIA AccTech Conference with the theme of Digital Evolution: Paving the Way Forward, which focused on the latest pivotal developments in technology to accelerate digital transformation in the accountancy profession. Insights from some of the sessions will be posted soon, stay tuned!

# Digital Technology Adoptions Awards

In promoting digital technology adoption in the accounting profession, the Digital Technology Adoption Awards (DTAA) was launched during the MIA AccTech Conference 2023. MIA is introducing the Awards to recognise remarkable achievements of technology application by the accounting profession in commerce and industry, public practice, and public sector. Recognition of successful technology implementations in the accounting profession will encourage others in the profession to undertake digital transformation. The DTAA is one of the initiatives under the MIA Digital Technology Blueprint that sets forth the direction for the accounting profession in Malaysia in responding to digital technology.

Watch this video and visit here to learn more about DTAA and how you can participate.

# 2023 Budget Commentary and Tax Information Booklet

Following the retabling of the 2023 Budget in February 2023, MIA, in collaboration with Chartered Tax Institute of Malaysia (CTIM) and The Malaysian Institute of Certified Public Accountants (MICPA) published the 2023 Budget Commentary and Tax Information Booklet. The Booklet has been posted to MIA members and the soft copy will be available to MIA members soon.

# Advocacy on taxation, financial reporting and public sector

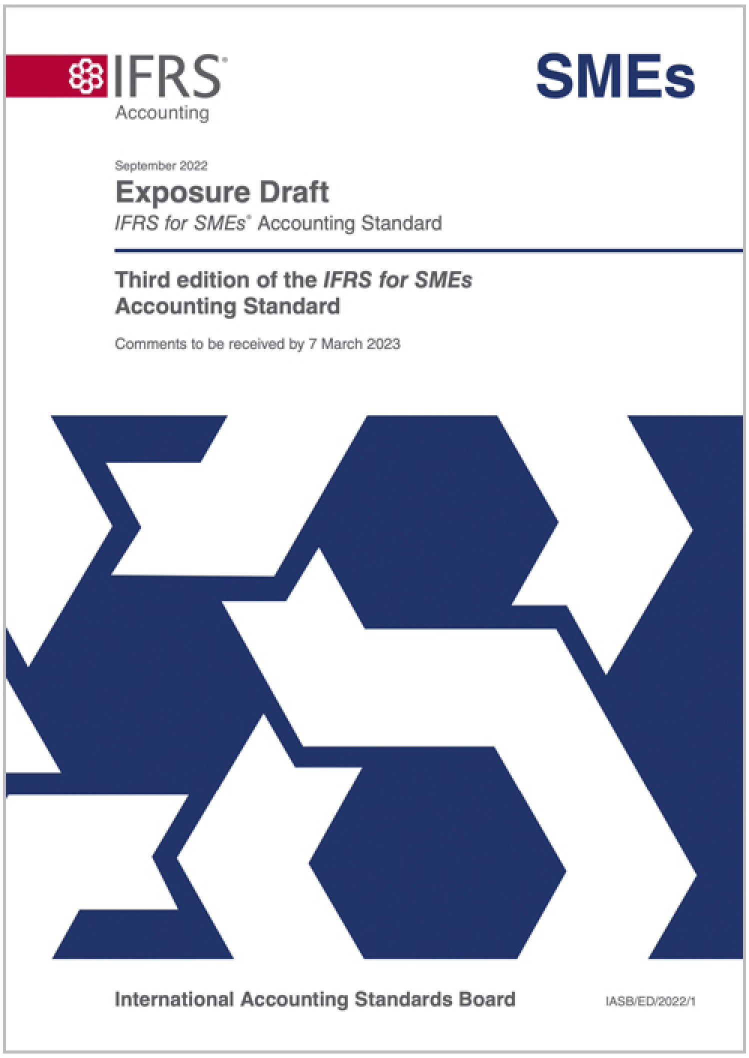
***Tax Treatment on Income Received in Malaysia from Outside Malaysia***

MIA and MICPA submitted a joint memorandum for tax treatment on income received in Malaysia from outside Malaysia to the Inland Revenue Board (IRB) in January 2023. The memorandum raised six issues arising from the legislation and the guidelines on tax treatment in relation to income received from abroad. Following the issuance of amended guidelines by the IRB, MIA and MICPA submitted a revised joint memorandum that incorporates four additional issues pertaining to the economic substance requirements in March 2023. The responses from the IRB have been circulated to members via Circular 13/2023.

***Reporting Sustainability Program Information***

The International Public Sector Accounting Standards Board (IPSASB) released Exposure Draft (ED) 83, *Reporting Sustainability Program Information* in November 2022. The objective of the ED is to provide additional guidance to facilitate the reporting of sustainability program information. This additional guidance will enhance awareness about the applicability of, and help in applying, the existing guidance in IPSASB's Recommended Practice Guideline 1 and Recommended Practice Guideline 3. MIA has submitted comments on the ED which can be viewed here.

***Third Edition of the IFRS for SMEs Accounting Standard***




The International Accounting Standards Board (IASB) published Exposure Draft *Third Edition of the IFRS for SMEs Accounting Standard* to update the IFRS for Small and Medium Enterprises (SMEs) Accounting Standard to reflect improvements that have been made in full IFRS Accounting Standards, while keeping the Standard simple for small and medium-sized entities. The proposed updates also include new requirements in IFRS Accounting Standards and other improvements that have been made to full IFRS Accounting Standards since the second edition of IFRS for SMEs Accounting Standard was published in 2015.

In Malaysia, the Malaysian Private Entities Reporting Standard (MPERS) is based on the IFRS for SMEs Accounting Standard. Any changes to the IFRS for SMEs Accounting Standard will normally be reflected in MPERS which will have an effect on MIA members who are in SMEs as well as the small and medium practices (SMPs) who are the auditors, preparers and advisors on MPERS financial statements. In February 2023, a roundtable discussion was held between the preparers, auditors and technical experts to create awareness on these potential changes to MPERS as well as collate views on the proposed changes in the Exposure Draft. Kindly view the comment letter here.

# Priority Research Topics (PRT) Programme Awareness Session

In February 2023, MIA and The Malaysian Accountancy Research and Education Foundation (MAREF), a trust body sponsored by MIA organised a Priority Research Topics (PRT) Programme Awareness Session.

Researchers of PRT 2.0 Programme, Dr Nik Herda (Taylor's University), Dr Kishan Krishnen (Universiti Sains Malaysia), Dr Arifatul Husna (Universiti Utara Malaysia) and Dr Mazni (University Malaya) shared their research findings at this webinar. Find out more about PRT2.0 short research reports here.

Meanwhile, the briefing on PRT 3.0 Programme was presented by Rasmimi Ramli (Executive Director, MIA), Simon Tay (Executive Director, MIA), Ng Boon Hui (Valuation Committee member) and Grace Ng (EY). The submission of research proposals for PRT 3.0 Programme closed on 31 March 2023.

# Raising Suspicious Transaction Reports (STRs) Under AMLA

at at-mia.my/2023/05/17/raising-suspicious-transaction-reports-strs-under-amla
May 17, 2023

**What RIs (Reporting Institutions) need to know about STRs**

*By Azizah Mohd Ghani*

Reporting Institutions (RI) are MIA members who hold valid practising certificates issued pursuant to Rule 9 of the Malaysian Institute of Accountants (Membership and Council) Rules 2001 and member firms that under the AMLA, are subject to Part IV Reporting Obligations of the Act, when they carry out any of the gazetted activities (GAs) as follows:

- buying and selling of immovable property;
- managing of client's money, securities or other property;
- managing of accounts including savings and securities accounts;
- organising of contributions for the creation, operation or management of companies; or
- creating, operating or managing of legal entities or arrangements and buying and selling of business entities

Accountants who only provide audit services which do not fall within any of the five GAs are not RIs under the AMLA. Bank Negara Malaysia (BNM) is currently in the midst of conducting a review to map out the services provided by accountants with the GAs and will communicate the outcome to the accountancy sector.

To enhance governance and compliance, RIs are required to raise suspicious transaction reports (STRs) under AMLA. Read more on STRs below.

**1. What is a Suspicious Transaction Report?**

A Suspicious Transaction Report (STR) is a document that RIs need to submit promptly to the Financial Intelligence and Enforcement Department (FIED) of BNM whenever there is any suspicion or reasonable grounds for suspicion that a client/prospective client (customer) is involved in any transactions/attempted transactions and/or engaged in any activity in Money Laundering (ML), Terrorism Financing (TF) or other serious crimes. STRs typically provide law enforcement agencies with valuable information and intelligence such as the identity of the parties involved in the transaction, the amount of money involved, the nature of the transaction, and any other relevant details of potential crime activities.

Submitting an STR does not necessarily mean that a transaction or activity is illegal or that any wrongdoing has occurred. It is simply a way for RIs to alert the authorities to transactions and/or activities that may warrant further investigation.

**2. When to submit an STR?**

RIs are required to submit an STR promptly whenever there is suspicion or reasons to suspect that the transaction (including attempted or proposed), regardless of the amount and/or activity engaged in:

- Appears unusual or does not fit the clients' business profile;
- Has no clear economic purpose;

- Appears illegal or tainted with illegality;
- Involves proceeds from an unlawful activity; or
- Indicates that the customer is involved in Money Laundering / Terrorism Financing (ML/TF).

**3. How do you recognise suspicious transactions?**


***Source:*** *iv INFOGRAPHIC SUSPICIOUS TRANSACTION REPORTS.pdf (bnm.gov.my)*

- **Screen** the client account
    - RIs need to know the client's personal particulars such as identification, nationality, contact details, occupation, nature of business, source of funds and income (when the client's risk rating is higher) and their purpose of transactions or services engaged by performing Customer Due Diligence (CDD).
    - RIs can only effectively control and reduce their Money Laundering/ Terrorism Financing (ML/TF) risk if the RIs have an understanding of the normal and reasonable activity of their clients, so that they have the means of identifying transactions and activities which fall outside their clients' regular pattern or activity.

- **Ask** the client appropriate questions.
    - Only upon knowing the clients' businesses will the RIs be able to ask the appropriate questions.
    - Raise questions on those transactions and/or activities, in particular, that involve new clients, a new line of business, transactions that do not make any economic sense, and payment received/paid which appears unusual.

- **Find** out the client's record/review known information
    - Ask appropriate questions to the clients.
    - If the clients hesitate or are unwilling to co-operate, that is the first sign that should trigger raising an STR.

- **Evaluate** information gathered and consider submitting an STR
    - Employees of RIs should raise any suspicions formed on clients to the Compliance Officer (CO)
    - Upon evaluation of established suspicion, the CO of an RI must submit an STR latest by the next working day from the date of establishing the suspicion.
    - RIs must not disclose to the clients or any other third party that an STR has been made, i.e., there should be no tipping off. However, certain exemptions to the tipping off offences are provided under *Section 14A (3) of the AMLA.*

RIs are required to establish a list of **red flags** relevant to their business or service to facilitate the detection of suspicious transactions. Examples of red flags are as provided in the AML/CFT DNFBP Policy Document (Please refer to Appendix 15 – Examples of Red Flags).


**DO**

- Ensure that STRs are submitted within the next working day, from the date the Compliance Officer establishes the suspicion
- Establish reporting mechanism for submission of STR
- Establish policies on the duration for Compliance Officer to review internal STRs
- Ensure that STR is treated with utmost confidentiality

**DON'T**

- Disclose submission of STRs to anyone else, except under certain circumstances (refer to Section 14A of Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 (AMLA) and Paragraph 20 of the Policy Document)
- Tip off the person(s) being reported - do treat them as normal clients so they do not suspect that STRs have been filed on them

***Source:* *iv INFOGRAPHIC SUSPICIOUS TRANSACTION REPORTS.pdf (bnm.gov.my)***

**Infrastructure Required to Support the Detection and Reporting of STRs**

- **Appoint an AML/CFT CO**
  - Appoint a CO regardless of the firm size. An RI may appoint any individual with management responsibilities within the RI to be the CO. However, the person appointed must satisfy the criteria provided under paragraph 11.5 of the AML/CFT Policy Document. Also, the CO must be in a position to have the sole discretion and independence to evaluate and report STRs.
  - Notify BNM on the appointment of CO within 10 working days, in writing/email to: fied@bnm.gov.my or through the CO Nomination Form *(preferred method). BNM* will then assign a CO Number for administrative purposes and for all correspondence with BNM.

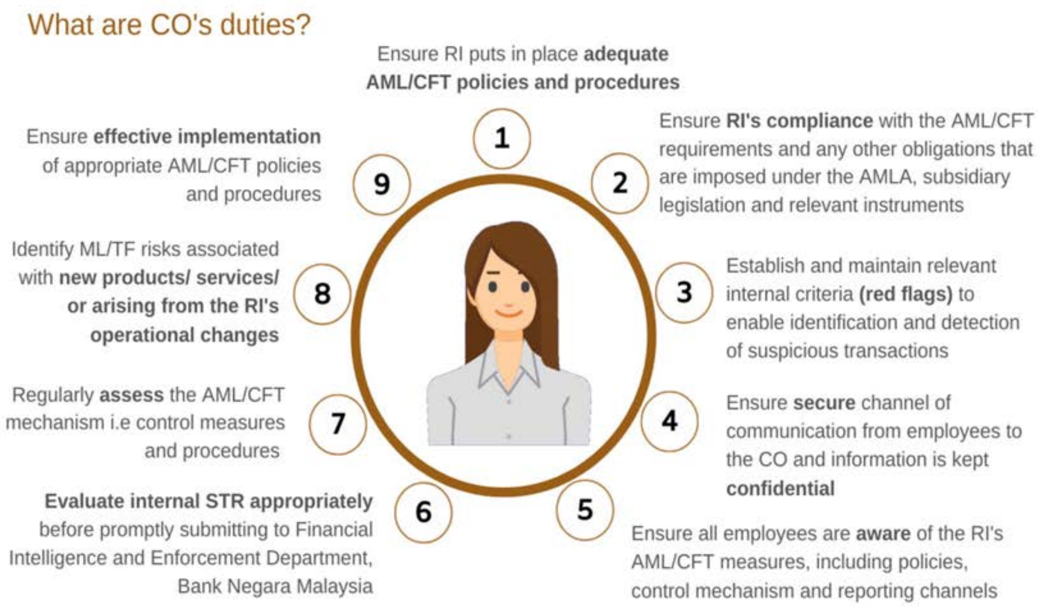
**What is the role of CO?**

A CO is the **reference point** for anti-money laundering and counter financing of terrorism (AML/CFT) matters within the reporting institution (RI).

A CO is legally required to submit suspicious transaction reports (STRs) on behalf of the RI.

**Criteria of CO**

- Have sufficient stature, authority and seniority within the RI to participate and be able to effectively influence decisions relating to AML/CFT
- Be fit and proper to carry out AML/CFT responsibilities effectively
- Have necessary knowledge and expertise to effectively discharge roles and responsibilities




***Source: BNM AML/CFT Policy Document – Appendix 11***

- **Establish a Reporting Mechanism**
  - RIs are required to ensure that there are policies and procedures in place and ensure the CO is responsible for channelling STRs received from the employees to be properly reviewed with a sufficient timeline. The policies and procedures must also cover the circumstances when the timeframe can be exceeded, where necessary.
  - Upon receiving any STRs, the CO must evaluate the grounds for suspicion. Once the suspicion is confirmed, the CO must promptly submit the STR. In the case where the CO decides that there are no reasonable grounds for suspicion, the CO must document and file the decision, supported by the relevant documents. The CO is to maintain a complete file whether or not the STR was submitted.
  - The CO must ensure that the STR is submitted within the next working day, from the date the CO establishes the suspicion.
  - RIs need to ensure utmost care is taken upon submission to ensure that such reports are treated with the highest level of confidentiality. The CO has the sole discretion and independence to report suspicious transactions.
  - RIs must also ensure that the suspicious transaction reporting mechanism is operated in a secure environment to maintain confidentiality and preserve secrecy.
  - The RIs must provide additional information and documentation as may be requested by the BNM and must respond promptly to any further enquiries about any report received under section 14 of the AMLA.
  - There is no threshold for STR as it can be raised based on suspicion.
  - All files with regards to STR should be kept for 6 years in a form admissible as evidence in court under the Evidence Act 1950.

- **Establish a Red Flags list**
  - RIs are required to establish internal criteria ("red flags") to detect suspicious transactions.
  - RIs must consider submitting an STR when any of its customer's transactions or attempted transactions fits the reporting institution's description of "red flags".
  - Reporting institutions may refer to Part E of the policy document for examples of transactions that may constitute triggers or any other examples that may be issued by the competent authority, regulatory bodies, Self-Regulating Bodies (SRB) and international organisations for the purpose of reporting suspicious transactions.
  - Among the general Red Flags are as below:

| CUSTOMERS | TRANSACTIONS | GEOGRAPHICAL LOCATIONS | DELIVERY CHANNELS |
|---|---|---|---|
| **Individual Customers**<br>Refuses to provide information / minimises the level of information required.<br><br>Refuses to provide personal contact without logical explanation.<br><br>Insists on the use of an intermediary (either professional or informal) without logical justification.<br><br>**Legal Persons or Legal Arrangement**<br>Sudden and unexplained increase in activities after being dormant for quite some time.<br><br>Where the director or controlling shareholder(s) cannot be located or contacted.<br><br>Possible linkages with criminal activities or countries under the sanction list. | Transaction conducted is questionable, or generates doubts that cannot be sufficiently explained by the client.<br><br>Transaction involves the use of multiple large cash payments without a logical explanation.<br><br>Customer regularly conducts transactions with international companies without sufficient corporate or trade justification. | Large numbers of incoming or outgoing fund transfers take place for no logical business or other economic purpose, to or from locations of ML/TF concern.<br><br>Legal persons or legal arrangements are incorporated/formed in a jurisdiction that has ML/TF concern.<br><br>Customer has unexplained geographic distance from the reporting institutions. | Use of a third party to avoid personal contact without logical explanation. |

*Note: the list above is non-exhaustive*

- **Sector Specific Red Flags for Accountants as provided below*:**
  - Receive large sums of capital funding quickly following incorporation or formation, which is spent or transferred elsewhere in a short period of time without commercial justification.
  - Received money through split transfers without logical explanation.
  - Transactions aborted after funds are received, then deposited funds were sent to a third party and personal contact avoided without logical explanation.
  - Clients having a history or tendency of changing accountants frequently without logical explanation.
  - Creation of fictitious employees under payroll list.

### STR Forms for Accountants

STR forms for accountants can be obtained via Appendix 5 (iii) of AML/CFT and TFS for DNFNPs and NBFIs or this link.

### What makes a quality STR?

The following information must be included in the STR:

- Information on the account holder or client or beneficial owner of the transaction or activity;
- Information on the person conducting the transaction and/or engaged in the activity;
- Details of the transaction or /and activity, such as the type of products or services, the amount involved and review period;
- A description of the suspicious transaction or its circumstances.
- Suspected offence; and
- Any other relevant information that may assist the FIED, BNM in identifying potential offences and individuals or entities involved.

**How to submit STRs?**

Completed STR forms must be submitted to the FIED, BNM through any of the following channels:

- E-mail to str@bnm.gov.my
- Mail to:
  Director
  Financial Intelligence & Enforcement Department
  Bank Negara Malaysia
  Jalan Dato' Onn
  50480 (Kuala Lumpur)
  (To be opened by addressee only)
- Financial Intelligence System (FINS) (where applicable)

**The importance of STR submission for RIs**

STR submission is important for RIs as protection from being abused. It is imperative that RIs protect their staff and firm from being abused to facilitate criminal activities and assist the law enforcement agencies in disrupting financial crime. In addition, submitting STRs and having a proper mechanism in place for STR reporting, will assist RIs in demonstrating that sufficient compliance measures are in place in instance of investigations by law enforcement agencies. **Non-compliance with the obligation** to report **STR** to BNM can entail a fine of up **RM1 million under the AMLA 2001.**

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*For further information on STR and other AML/CFT compliance requirements, please refer to the BNM's AML/CFT website: https://amlcft.bnm.gov.my/*

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*Azizah Mohd Ghani is the Head of Professional Accountants in Business (PAIB) and Valuation Department of the MIA.*

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*More information on RIs is available at: https://www.at-mia.my/2022/05/20/obligations-by-reporting-institutions-under-amla/*

# Taking Fear Out of Tax Matters

at [at-mia.my/2023/06/26/taking-fear-out-of-tax-matters](at-mia.my/2023/06/26/taking-fear-out-of-tax-matters)
June 26, 2023

***By Aufa Mardhiah & Anis Zalani***

Thereis no mistaking the adversarial relationship between the tax authorities and taxpayers. It is so pervasive that the taxman is seen as the bad guy, seeking to make the people and corporations to owe up to their payments to the government's coffer.

Any chance of changing the face of the tax collectors? Well, an attempt is underway.

One of the components, on the corporate front, is known as cooperative compliance.

"The challenge is that we've always had what we call an adversarial relationship between the tax authorities and taxpayers. So, the issue is about taxes, leading to improvement and trying to regain this public trust. That is crucial so that everyone can function effectively in the system. We do that because you need to improve compliance, you need to increase the tax revenue collection," tax industry veteran Dr Veerinderjeet Singh told a recent conference in Kuala Lumpur.

> The issue of trust is important enough that it warranted a panel session of its own at the Malaysian Institute of Accountants (MIA) annual event a fortnight ago. It was entitled "Overcoming trust displacement through cooperative compliance initiatives".

The brief for the session had this to say: Strengthening cooperative compliance can uplift tax governance by building a reciprocal relationship of trust and co-operation between businesses and tax authorities.

As a bridge between our stakeholders, the profession can champion cooperative compliance to heighten accountability and transparency, improve tax administrative efficiency, enhance certainty for business, and foster trust and confidence in the tax system.

## Why The Introduction of Cooperative Compliance?

"Largely because it assisted building trust," said Veerinderjeet, noting that it primarily looked at the larger entities. It was about an attempt to establish a better relationship between those taxpayers and tax authorities.

"The reliance here is on inter- nal controls of the entity because the controls are functioning well, you're collecting the data that you need to be able to import the tax liability. And there is a fair level of assurance that you are having a relatively good system to capture the data," he said.

This comes under the Tax Corporate Governance Framework (TCGF). It establishes the techniques and processes within the organisation to identify tax risks, assess risks and set out the appropriate actions to mitigate the impact of those tax risks.

An effective tax corporate governance framework can cultivate a level of confidence that the organisation is reporting and paying the right amount of tax, enabling organisations to achieve greater certainty in relation to their tax affairs.

TCGF was introduced by the Inland Revenue Board (IRB) in April 2022. It brings into action tax cooperative compliance, an initiative for promoting better tax compliance developed by a forum under the Organisation for Economic Co-operation and Development (OECD).

Tax cooperative governance has set out expectations for transparency and good tax governance by the taxpayer to provide a high degree of reassurance as to the control of tax risk processes and the absence of aggressive tax planning, according to a blog entry by PWC Malaysia.

It noted that the global trends outline how tax authorities are pushing for more transparency and governance. For instance, by providing definition and their expectations (such as in the UK, large businesses are required to publish their tax risk policies or strategies, Malaysia and Singapore have Corporate Income Tax programmes) or by types of taxpayers (the UK, Malaysia, Singapore — by size of operations, Australia — by risk profiles).

After the successful implementation of the Assisted Compliance Assurance Programme (ACAP) in Singapore, PWC Malaysia highlighted the recent rollout of their Tax Risk Management and Control Framework for Corporate Income Tax (CTRM).

As there has been a greater push for tax corporate governance or tax control frameworks globally, in a manner that is consistent with OECD guidelines, Malaysian groups are revisiting their tax policies and controls, it added.

TCGF is suitable for all sizes and types of businesses that give priorities and resources to corporate governance matters, according to information at IRB's website. It noted that the programme is currently being implemented as a pilot project, expected to run from June 2022 to June 2024. The programme will be open to all organisations once the pilot project phase is over.


## Making It Work

At the moment, there are about a dozen large corporations that are involved in IRB's pilot project for cooperative compliance, with one of them being the national oil company Petroliam Nasional Bhd (Petronas). Naturally, transparency and mutual trust are key elements. Without doubt, these are areas that the authorities would have to work hard to win the support of the taxpayers.

In making it work, IRB CEO Datuk Dr Mohd Nizom Sairi said that transparency is mutual. He shared his personal experience when he started work with the tax authority in 1985. "Generally, the taxpayers then believed that the less that the revenue (IRB) knows about them, it's better for them. But actually, it's the other way around," he told the conference. Another tax expert observed that the framework would work best if it was adjusted to the needs of the local corporations, especially the smaller companies. Thannees Tax Consulting Services MD SM Thanneermalai said he has been talking about cooperative compliance for some years now, minus the buzzwords used by OECD.

"We need to Malaysianise it. You can't just take it from the OECD. You have to bring things to ground reality," he said. "TCGF is excellent, and I support it, but it has to be made a lot easier."

Commenting on trust, Thannee, as he's known within the tax fraternity, agreed with IRB's Mohd Nizom that trust is a two-way thing.

"At the end of the day, what OECD and all the others talk about is to provide you with certainty.

It provides you comfort that the information given is correct, tax is paid on time and that (the authorities) are collecting the right amount of tax. At the end of the day, the authorities want to collect the right tax. How do you build trust? All multi-national companies (MNCs) today are already focusing on spending resources on compliance," he said.

However, he does not see a similar uptick in the compliance fer vour in Malaysia. Here, he said a conference on compliance will not attract the crowd.

> "Our mindsets haven't entirely changed. There is change at Petro- nas because they are exposed to the international environment," he said.

Thannee also highlights the importance of certainty to the taxpayers. "They got to see that, at the end of the day, it's not just the revenue or people collecting the right amount of tax, but what they seek — certainty, communication and relationships."

On Petronas' involvement in the pilot project, its senior GM for group tax Rihanna Haryanti Mohd Ramli said the company, being an MNC, with some 350 companies operating in 60 countries, has been exposed to various devices.

The Malaysian oil giant had its initial exposure to cooperative compliance due to its presence in the UK. When it got wind that IRB was embarking on the TCGF, Petronas decided to jump on board. "It's all about having the ease of mind," she said.

For the long run, though, many of the tax executives are hoping that tax authorities would not depart from its current course. That, in itself, would provide corporations certainty.

When talking at the MIA conference, Rihanna Haryanti, too, had raised the issue of certainty. She said one of their concerns is about sustainability. "We are starting on the right path. Would the same environment fully continue? That, to me, is still a question mark… When a leader has a particular way of looking at things, it cascades down," she said.

## Compliance and Enforcement

IRB is the authorised authority in Malaysia's tax system that deals with direct taxes and it is an agency established by the finance ministry to serve as an agent in assessing, administering, collecting and enforcing the payment of income tax and other taxes under the board's jurisdiction.

Nonetheless, what motivates individuals and businesses to pay taxes? A report titled "Tax Reforms — The Way Forward for the Malay- sian Tax System" by the Malaysian Institute of Certified Public Accountants (MICPA) with Deloitte stated that the inherent willingness to pay tax can substantially aid the government in the design and administration of tax policy, particularly in developing nations with poor compliance rates.

The report also stated that voluntary compliance, however, is decided not simply by tax rates or the prospect of penalties, but by a variety of socioeconomic and institutional factors that differ across locations and people.

"Tax administration needs to have the conditional formatting — you need to identify what required changes so that you can see what you need to look at to get you by the system," said Veerinderjeet, the immediate past president of MIA. He is also an independent non-ED at public-listed UMW Holdings Bhd.

An OECD study, mentioned in the same report by MICPA and Deloitte, recommended that tax administrators simplify the process of filing tax returns, while the government ensures transparency and accountability in tax revenue to improve trust in government and tax administration.Aside from that, the report stated that digitisation is also important in tax administration to boost tax administration efficiency and effectiveness.

According to the report, this process has helped to reduce burdens to varying degrees for different taxpayer segments, for example, improvements in taxpayer services such as e-filing, e-pay- ment, online self-service tools and targeted help such as online live chats have made it easier for taxpayers to understand and meet their tax obligations.

> However, despite the advancements which have benefitted both taxpayers and tax administrators, the report highlighted that the existing tax administration system still has substantial limitations in terms of the outcomes it can produce.

Among the limits are the time and money required to pay tax responsibilities. Taxpayers must actively participate in understanding, processing, calculating and reporting tax responsibilities, as well as maintaining records for tax audit and investigation reasons. As a result, the overall costs of compliance, including both monetary and opportunity costs, can be high.

In the earlier mentioned report, Veerinderjeet stated that an income tax system is based on the willingness of citizens to pay their taxes voluntarily — which requires the tax agency to adopt a philosophy of having outreach and educational programmes to promote voluntary compliance.

"Studies on taxpayer behaviour do seem to suggest that services to taxpayers that facilitate the reporting, filing and paying of taxes, or that impart education or information among citizens about their obligations under the tax laws, may in many circumstances constitute a more cost-effective method of securing compliance than measures designed to counter non-compliance.

"This would involve providing certainty and clarifying legal ambiguities, communicating clearly and assisting in lowering the costs of compliance to taxpayers. There is much to be gained from viewing taxpayers more as clients than would-be defaulters," he said in the report.

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# The Capital Market Advisory Committee (CMAC) and the Malaysian Investment Reporting Standards (MIRS)

**at-mia.my**/2023/06/27/the-capital-market-advisory-committee-cmac-and-the-malaysian-investment-reporting-standards-mirs
June 27, 2023

*By the MIA Capital Market Advisory Committee*

The Capital Market Advisory Committee or CMAC was created as a non-statutory committee by the Malaysian Institute of Accountants (MIA) in April 2013 with the following main objectives:

- To serve as liaison between MIA, regulators and key stakeholders on capital market related matters.
- To consider practical problems faced by members relating to the application and compliance with the regulations of the capital market and make recommendations to the relevant authorities.
- To consider and recommend principles of good practice on issues not covered by Auditing and Assurance Standards Board (AASB) and the Ethics Standards Board (ESB) pertaining to capital market practice.
- To formulate and provide guidance notes for the MIA Council to be issued to members on various aspects of capital market practice from time to time.

The latest information on the Committee can be accessed here.

CMAC members currently consists of practitioners who are reporting accountants (RA), a tax practitioner and two observers from the Securities Commission (SC) and Bursa Malaysia respectively. Under its terms of reference, CMAC meets at least twice a year.

## Malaysian Investment Reporting Standards (MIRS)

In 2018, CMAC initiated the development of appropriate reporting standards for capital market transactions in Malaysia so that reporting accountants and preparers and/or listed issuers are well-guided and consistent in dealing with capital market transactions and reporting. The development of these standards entailed extensive jurisdictional research, consultations and discussions which are partly funded by a grant from the Capital Market Development Fund (CMDF), a trust fund under the purview of the SC, whose purpose is to support the development of the Malaysian capital market. The MIA has since re-applied for and successfully obtained a new grant in the current year, enabling CMAC to continue its work on the MIRS.

Prior to issuance of the first MIRS standard in 2021, there was no formal framework governing the principles and essential procedures with which a reporting accountant (RA) in Malaysia was required to comply in the conduct of an engagement connected with an offer or invitation to subscribe for or purchase any securities of a corporation, a business trust or a real estate investment trust, including any excluded offer or excluded invitation, as defined under the Capital Markets and Services Act 2007 and post-listing transactions. Likewise, guidance materials for preparers and/or listed issuers were limited (such as MIA's Guidance Notes). Hence, the MIRS were conceived with the purpose of addressing and resolving divergent practices in the Malaysian capital market especially among the RA community as well as driving consistency in the treatment of capital market transactions and reporting.

While the RAs have always worked closely with the Malaysian Investment Bankers Association (MIBA) to arrive at consensuses on best practices and mutually agreed terms, the results of such collaborations were not widely published, contributing to a lack of knowledge in the public domain. This is not desirable for the Malaysian capital market in the long run.

Against this backdrop, MIA approached the SC and Bursa Malaysia in 2018 to produce a unified approach to capital market reporting as seen in more developed markets of the United Kingdom and Hong Kong. Preparers and listed issuers as well as the RAs would be guided to know their work scope and responsibilities better. This would eventually lead to more knowledgeable and competent preparers, RAs and Principal Advisors. Ultimately, this unified approach aims to meet the greater objective of facilitating convergence in practices, improving compliance and thus, boosting investor confidence in the Malaysian capital market.

The first standard, the MIRS 1000, setting the framework for the rest of the impending standards was issued in May 2021 after a lengthy period of exposure and deliberations. This was followed by the issuance of MIRS 2030 in January 2022. The next MIRS is expected to be issued in 2023.

MIRS 1000 sets out the framework for the RA's scope of work pertaining to investment circulars prepared for issuance in connection with a capital market transaction governed wholly or in part by capital market laws and regulations of Malaysia. It establishes basic principles and essential procedures that are common to all reporting engagements (both public and private) relating to investment circulars. MIRS 2030 provides guidance to the RAs on their responsibilities when engaged to report on the Statement of Capitalisation and Indebtedness included in an investment circular.

Other MIRS in the pipeline are:

**MIRS 2000**

PROPOSED INVESTMENT STANDARDS

Malaysian Investment Reporting Standards applicable to Public Reporting Engagements on Historical Financial Information

ACTION PLANS

To formulate general requirements applicable to reporting engagements on historical financial information and consider other requirements to be included.

DELIVERABLE

Proposed MIRS 2020 *(Historical Financial Information)*

**MIRS 3000**

PROPOSED INVESTMENT STANDARDS

Malaysian Investment Reporting Standards applicable to Public Reporting Engagements on Proforma Financial Information

ACTION PLANS

To formulate general requirements applicable to reporting engagements on pro-forma financial information and consider other requirements to be included.

DELIVERABLE

Proposed MIRS 3020 *(Pro-Forma Financial Information by Reporting Accountants)*

**MIRS 4000**

PROPOSED INVESTMENT STANDARDS

Malaysian Investment Reporting Standards applicable to Private Reporting Engagements on Prospective Financial Information

ACTION PLANS

Pending for issuance of this standard

DELIVERABLE

Proposed MIRS 4010 *(Working Capital Sufficiency Statement)*

**MIRS 5000**

PROPOSED INVESTMENT STANDARDS

Malaysian Investment Reporting Standards applicable to Comfort Letters and Due Diligence Working Groups

ACTION PLANS

To formulate the general requirements applicable to reporting engagements in respect of issuing a comfort letter and participation in due diligence working groups as well as consider other requirements to be included.

DELIVERABLE

Proposed MIRS 5010 *(Comfort Letters and Due Diligence Working Groups)*

## Other Initiatives

CMAC recently worked with MIBA to finalise the latter's Equity & Debt Capital Markets Due Diligence Guides that were issued in January 2021. These industry guides are a collaboration by various stakeholders of the Malaysian equity and debt capital markets to update, enhance and clarify the due diligence standards and practices in relation to the preparation and submission of corporate proposals and offering documents to the SC. These guides encompass the various aspects of due diligence including the scope and extent of due diligence in a corporate proposal as well as the roles of participants involved.

CMAC has also actively responded to various consultative documents issued by the SC and Bursa Malaysia over the years.

In addition, CMAC is the architect of the Capital Market Conference organised since 2017 by MIA and supported by the SC and Bursa Malaysia. The conference took a hiatus in 2020 due to the COVID-19 pandemic and reconvened in June 2021.

## Impact to MIA members

It is important for members of MIA who are preparers of reports in connection with prospectuses and other investment circulars or RAs to be aware of all related initiatives and the applicable standards in investment reporting. The MIRS series is a set of reporting standards binding on all MIA members. Similar to other mandatory requirements, members found to have failed in complying with these standards without reasonable justification can be subjected to MIA's investigation and disciplinary procedures if a complaint is received by these statutory committees. Members are reminded to be fully conversant of these standards when carrying out their professional duties, either as a preparer or the RA. This responsibility is also incumbent upon the MIA members' staff who eventually report to him or her on a direct basis.

As part of CMAC's commitment to sharing knowledge, webinars that are mostly complimentary are organised on a regular basis for the education of members and non-members. In 2020 and 2021, CMAC held complimentary outreach sessions on the "Guidance Note on Accountants Report by Reporting Accountant", "Guidance Note for Issuers of Pro Forma Financial Information", and "MIRS 2030". Apart from these, CMAC also participated in outreaches held by other stakeholders. In February 2021, MIBA held a virtual outreach session to brief participants on the recently released Equity Due Diligence Guide. CMAC's Chair, Mr Teoh Soo Hock, was a panel member and shared on topics such as the RA's roles and responsibilities, scope of work and relevant best practices.

In addition, the MIA's Professional Development department also frequently holds training programmes on capital market-related topics such as "Pre & Post IPO Rules and Key Updates to Listing Requirements" and "Pathway to Equity Capital via Initial Public Offering (IPO)".

With a unified approach to investment reporting, CMAC will be in a strong position to upgrade the quality of work of preparers and RAs alike over time. This can only augur well for the capital market in Malaysia.

# The Future Relevance of Integrated Reporting and its Role within the Sustainability Context

**at-mia.my**/2023/06/28/the-future-relevance-of-integrated-reporting-and-its-role-within-the-sustainability-context
June 28, 2023

*By Geetha A Rubasundram*

The international focus on sustainability has led to a growing demand for organisations to articulate their sustainability initiatives in their corporate reports using a plenitude of frameworks, guidelines, standards and regulations for organisations. There is also a move from merely reporting metrics and targets in silos to the integration of sustainability with the strategy, governance and risk management activities within the organisation's value creation process. One particular tool that advocates this integrated mindset and thinking is Integrated Reporting that has received global prominence over the years. However, with the recent developments and convergence of the various frameworks and standards as well as enhanced sustainability reporting requirements, some have questioned the continued relevance of Integrated Reporting. This article explores the ideology behind Integrated Reporting and its applicability within the sustainability context.

## Introduction

Organisations play a significant role in collectively combating climate and other sustainability related issues. Although there are significant numbers that have actively embraced sustainability within their business environment, there are many who are still contemplating their journey or prefer to "wait and see". These are not straightforward decisions and require considerations of trade-offs and consequences over the short, medium and long term. However, looking at the abundant opportunities and resources that could avail themselves to organisations regardless of size and background, it is recommended that organisations actively engage their teams to embrace sustainability within their context.

Apart from the philanthropic advantages, organisations should consider the financial benefits and resources that could come their way by being sustainable. The increasing number of sustainable finance products and resources provides organisations with financing options that are more cost effective and attractive. However, organisations need to showcase the sustainability perspective within their projects or operations to avail themselves to financial products that necessitate the processing and reporting of key information (both financial and non-financial).

In reality, many organisations struggle to align their sustainability efforts; whether in terms of the requirements of external reporting or aligning their internal mechanisms, components and performance measurements with a strategic perspective. The typical box-ticking checklist is definitely insufficient to meet the growing reporting needs, especially with the increasing focus on the risk of greenwashing. It is also crucial to recognise the burden of the cost of reporting and compliance that may demotivate organisations from proceeding further in pushing this much needed agenda in the future. This is further aggravated by the plethora of regulations, frameworks and guidelines that govern sustainability reporting across regions. There has been promising developments with the collaboration of the various bodies, organisations and stakeholders to create a more aligned effort in terms of sustainability led initiatives and reporting such as with the convergence and consolidation of several entities under the IFRS Foundation, which builds on the works of the Value Reporting Foundation, Sustainability Accounting Standards Board (SASB), Task Force on Climate – Related Financial Disclosures (TCFD) and many others for the setting of a global baseline sustainability standards. Though interim challenges are anticipated until a more robust and aligned reporting mechanism is in place, it must also be remembered that different industries and issues require different data and information.

## Reporting Sustainability Initiatives in an Integrated Manner to Create Value

Even at this stage, the terms Environment, Social, Governance (ESG) and Sustainability are used interchangeably, with some organisations still referring to Corporate Social Responsibility (CSR) even though there are significant differences and developments that distinguish them. The ESG reporting landscape may be more familiar to many reporting organisations.  Although it does have its own advantages and has played a significant role in pushing forward a focus in terms of ESG, it is pertinent for organisations to evolve from the rather disconnected ESG disclosure perspective to an integrated approach to report sustainability related initiatives.

Regardless of the terminology, a significant issue is the perception that sustainability/ESG/CSR efforts are disconnected from the financial motivations of an organisation. One factor that could have contributed to this is the lack of a relevant definition of sustainability over the years for corporates to consider in line with their strategies resulting in them looking at it from a philanthropic or stewardship angle. A welcomed development from the International Sustainability Standards Board (ISSB) in terms of the definition of sustainability makes it more relevant and applicable to organisations.

The ISSB is the standard setting body established under the International Financial Reporting Standards (IFRS) Foundation to create and develop sustainability-related financial reporting standards. Sustainability is defined in the ISSB's General Sustainability-related Disclosures Standard (S1) as the ability for a company to sustainably maintain resources and relationships with and manage its dependencies and impacts within its whole business ecosystem over the short, medium and long term. The ISSB also asserts that it is advantageous for organisations to clearly articulate the relationship between sustainability related matters and its value creation (including financial). However, it must be pointed out that the debate between single and double materiality is still a crucial discussion point.

Whilst the above may seem simple enough, implementing it requires resources and commitment of organisations to align their people-process-technology to value creation strategies. Organisations face their own levels of complexities depending on the phase of reporting maturity and leadership competency. Organisations need to understand that disconnected reports are apparent to their users and stakeholders, and this reduces the value attached to the organisation and impacts the resources that may be availed and allocated to it. It is also an opportunity for the organisations to narrate their own value creation story to attract resources and opportunities. The use of Integrated Thinking removes the disadvantages of silo-based management. Integrated Reporting considers all of the above and more, making it an attractive tool. These advantages are expanded in the next section.

## The Relevance of Integrated Reporting

The merging of the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) to form the Value Reporting Foundation (VRF) was a welcomed initiation to ensure further integration of these many frameworks and initiatives. This also strengthened the prominence of the Integrated Reporting Framework for the future of corporate reporting. The subsequent consolidation of the VRF with the IFRS Foundation in 2022 further cemented the efforts to work together to support the work of the ISSB especially with the inclusion of the Climate Disclosure Standards Board into the IFRS Foundation.

VRF has built its advocacy based on the SASB Standards, the Integrated Reporting Framework and the Integrated Thinking Principles. The VRF's SASB Standards provides the initial platform for the development of the IFRS Sustainability Disclosure Standards and the Integrated Reporting Framework provides the connectivity between financial and sustainability-related financial disclosures. Both the IFRS Foundation's International Accounting Standards Board (IASB) and the ISSB have taken joint responsibility and are actively encouraging the continued adoption of the Integrated Reporting Framework. These external developments itself should reflect not only the relevance but the crucial necessity to consider Integrated Reporting as part of any organisations future reporting requirements. This recognition of Integrated Reporting is due to its ability for organisations to report and embody their unique value creation story which would attract resources and network through their integrated thinking culture. The flexible yet guided mindset enables organisations to include sustainability actions and impacts into the organisational strategic planning and decision making process as well as its performance measurement system.

However, to further elucidate the advantages of Integrated Reporting in aligning both financial and sustainability-related disclosures, it is necessary to discuss its propositions and concepts. The Integrated Reporting Framework helps organisations articulate how they use and effect resources (natural, manufactured, human, social and relationship, intellectual and financial) as well as relationships for creating, preserving and eroding value over time (short, medium and long term). This enables an organisation to concisely present to its investors its ability to work sustainably within its business ecosystem taking into account the impacts, risk and opportunities that affect its prospects and performance. The Integrated Report also provides flexibility for linking sustainability initiatives to the Global Reporting Initiative (GRI), TCFD, the Sustainable Development Goals and others.

In order to achieve this depth and connectivity of reporting, an organisation needs to align its people-process-technology platform to the organisation's strategies and values. The integrated thinking mindset plays a crucial role here as well. Once aligned, the organisation tends to be lean and agile, since unnecessary and redundant reports, processes etc. are removed. It is crucial to identify the inputs, outputs and outcomes that would be relevant to their monitoring and reporting mechanisms. The volume and complexity of data and reporting systems need to be identified and broken into phases to complement the organisation's ability to commit its resources. This is a continuous improvement process and organisations should not be overzealous in achieving what they would consider to be a perfect report. It should be kept real though with a sense of commitment from all levels of the organisation. Combing through reports of organisations over the years would reflect this phased development and it is always interesting to see their journey. One good example that the readers could use as a reference is the Malaysian Institute of Accountants (MIA) Integrated Report that reflects its journey and value creation over time.

However, apart from the internal mechanisms identified above, organisations need to assess their own strategies and long term value creation. It is a balancing act and due to resource constraints, decisions would need to be made on what to concentrate on over the short, medium and long term. In this context especially, it is important to engage stakeholders to identify significant issues. Organisations then assess. prioritise and implement solutions to material issues whilst taking into account an in-depth risk assessment aligned to its strategies to ensure they are able to sustain themselves financially whilst being responsible and socially significant. Many organisations have included sustainable risk methodologies within their risk strategies reflecting their focus in embedding sustainability strongly within their business environment.

Organisations that have embarked on the integrated thinking process and integrated reporting framework report stronger communication bonds between all levels of the organisation. They react faster to the volatile movements within the business environment. This is also reflected in the governance of the organisation where the commitment of the board is reflected in terms of their time, competency and assessments as well as the ability to make better decisions due to the quality of information provided in a timely manner.

Organisations should also be aware of the rising demand for assurance on sustainability-related disclosures. There should not only be consistency but also reliability, considering how the contents of their reports can be verified. Greenwashing is a growing issue and this has been highlighted in the last COP 27. There are also developments in terms of taxonomy and law to mitigate the issue of greenwashing which increases the liabilities and responsibilities of boards and management within the sustainability context. The focus on integrating thinking and alignment of the people-process-technology platform with sustainability initiatives should provide the organisation with relevant data and information that are substantiated and assured (with supporting documents and trails), hence reducing the risk of greenwashing.

## Conclusion

Integrated Reporting continues to be relevant and under the auspices of the IFRS Foundation, its reach will only get wider and its efficacy more globally realised. It is heartening to note that various organisations have achieved significant milestones in reporting their sustainability initiatives in alignment with the value creation strategies. This motivates organisations of similar background and size to emulate the same. Each organisation has its own unique value creation story and journey. It is pertinent to articulate this uniqueness in a concise yet relevant manner for users of the report to form a holistic view and rely on the consistency of the report over the short, medium and long term. The same expectation of accountability, transparency and assurance levels should be implemented for these reports and contents in line with the rigour applied to financial reports. In the fine print, the reports normally have the disclaimers of the risk of future based information that may change due to external conditions. Whilst this may be logical, it should not be the basis for any careless representation of information. There have been unfortunate cases of organisations that have been well recognised for the quality and depth of their reports as well as the connectivity of the information; but have later been charged with misconduct or fraudulent reporting. Hence, users of these reports should be alert and, where necessary, carry out the necessary due diligence. The future holds much hope in terms of pushing forward successful sustainable initiatives with collective action by all stakeholders including these exciting developments in regulations, frameworks and guidelines, standards relating to the future of reporting. Within this context, Integrated Reporting is definitely a much needed and relevant tool to assist organisations to ensure their reporting journey becomes more structured, integrated and consistent as well as aligned to their sustainable value creation journey.

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# The MIA Sustainability Agenda

at **at-mia.my**/2023/06/28/the-mia-sustainability-agenda
June 28, 2023

*By MIA Sustainability, Digital Economy and Reporting Team*

The call for sustainability adoption is currently in the global spotlight, simultaneously inducing the requirement for disclosure on sustainability and climate change-related areas from organisations. Stakeholders such as investors and the public at large are demanding organisations' transparency on environmental and social impacts as this is critical to managing severe global risks. Based on the Global Risks Report 2023 published by the World Economic Forum (WEF) highlighting the top ten risks over a 2-year period and 10-year period, eight of these relate to environmental and societal risks.

The International Federation of Accountants (IFAC) states that with the establishment of the International Sustainability Standards Board (ISSB), the way forward for the accountancy profession is to lead climate reporting and other material disclosures on environmental, social and governance (ESG) matters together with their assurance.

FAC in its February 2023 publication entitled *Time for Action on Sustainability: Next Steps for the Accountancy Profession* emphasised that accountants should advocate for smart sustainability-related policymaking and regulation starting with the support of the new ISSB and assurance of sustainability disclosures. The new role requires adoption of an integrated mindset by breaking down information silos within organisation and promoting interconnection.

By being proactive in sustainability-related reporting, accountants can help organisations to comply with industry best practice and imminent requirements. In order to achieve this, accountants need to demonstrate sustainability-related competencies to ensure the profession continues to expand its value-added capacity in future.

Furthermore, one of IFAC's latest publications, *Insights from IFAC's Professional Accountants in Business (PAIB) Advisory Group*, highlights that finance leaders need to ensure appropriate governance and management structures to balance between empowering team members to make critical decisions at frontline speed while still maintaining effective oversight, lines of authority and accountability.

Sanjay Rughani, Chair of the IFAC Professional Accountants in Business Advisory Group emphasised that organisations are turning to their accountants to help stay afloat and navigate a future pathway to resilience. As a result, accountants need to adapt and assume new roles and functions in sustainability for them to continue adding value to the organisation.

In response to these developments, the Malaysian Institute of Accountants (MIA) sustainability agenda is a two-pronged approach that advocates sustainability for the Institute and for the accountancy profession in order to be future relevant, by enhancing the profession's competency, protecting public interest and supporting sustainable nation building.

> "As the regulator and developer of the profession, MIA has identified climate change and ESG issues as game changers that will reset the global business ecosystem. As Malaysia pursues its pathway to a low-carbon economy, accountants are ideally positioned to be a strategic partner for companies' transition towards a more sustainable future," said MIA President Datuk Bazlan Osman.

"Needless to say, value-added capacity and competency building will be imperative to drive the MIA's two-pronged sustainability agenda. In terms of competency building, MIA is evaluating how accountants can harness their ethics, professionalism, unique competencies and financial expertise to help drive the ESG agenda in the short, medium and long term to support business and economic sustainability, and integrating these components into our extensive professional development programmes," said MIA CEO Dr Wan Ahmad Rudirman Wan Razak

Among the areas the MIA sustainability agenda will focus on are governance, accounting, people, reporting, process, assurance, systems, regulation and guidance. These are fundamental areas relevant to the accounting profession and the Institute where the sustainability agenda needs to be mapped and addressed.

MIA is in the midst of developing the MIA Sustainability Blueprint for the Accountancy Profession (the Blueprint) and MIA Sustainability Framework and Targets (the Framework). The Blueprint focuses on advocating sustainability for the accountancy profession whereas the Framework outlines the MIA sustainability agenda for the Institute. The Sustainability Blueprint Task Force (established by the MIA Council) and the MIA Management Team will oversee the development of the Blueprint and the Framework respectively.

While developing the Blueprint and Framework, MIA will continue its advocacy and capability building efforts on sustainability for the accounting profession in Malaysia.

# The Pursuit of Continuous Audit Quality Improvement: QAP Stories from KS Chia & Associates and Steven Lim & Associates

at **at-mia.my**/2023/05/11/the-pursuit-of-continuous-audit-quality-improvement-qap-stories-from-ks-chia-associates-and-steven-lim-associates
May 11, 2023

*By the MIA SMP Department*

The past few years are a testament that the world demands agility to adapt to unprecedented changes. What is of utmost importance to audit firms is to be able to adapt and progress, always enhancing the audit experience whilst sustaining quality with objectivity and independence being top of mind.

Amidst the collective changing realities, commitment to audit quality remains strong post pandemic for KS Chia & Associates and Steven Lim & Associates. One of the ways the firms demonstrated their continuous improvement mindset to enhance audit quality is by signing up for the Quality Assessment Programme (QAP). Below, KS Chia & Associates and Steven Lim & Associates share their experiences with QAP participation.

## Brief profile of the firms

KS Chia & Associates is a sole proprietor firm with over 20 staff focusing on the provision of audit services. Sole proprietor, Chia Ken Seng has 20 years' experience in public practice. The firm started its QAP on 5 October 2022 and the final report was issued on 1 December 2022.

Steven Lim & Associates is a partnership firm which predominantly provides audit services besides other ancillary services. The firm has 6 branches and 3 partners overseeing more than 40 staff. The partners, Lim Hoo Teck, Gan Soon Huei and Chua Ser Terk have more than 35, 15 and 15 years of experience in public practice respectively. The firm commenced its QAP on 25 April 2022 and concluded with the issuance of a final report on 17 August 2022.

Here are their QAP stories:

**How did you know about the Quality Assessment Programme (QAP)?**

**KS Chia & Associates**: I got to know about the QAP from the seminars and webinars that we had attended and from the MIA's email blast.

**Steven Lim & Associates**: From various MIA sources, such as the notices and articles in e-Accountants Today.

Also, we are attracted by some pull factors such as the reduction in maximum fee from RM10,000 to RM6,000 and the introduction of the 12-month improvement period allowed for QAP firms, during which QAP participating firms will not be selected for practice review.

**Please describe the QAP process briefly.**

Firstly, we provided the coordinator with our available date and time and selected an audit engagement for the review. Then, we had a virtual kick off meeting with the reviewers before the commencement of the QAP. During the review, the reviewers spent two days of fieldwork at our firm, reviewing the selected audit engagement and our firm's ISQC 1 manual.

After the fieldwork, we attended the QAP feedback catch-up session before the closing meeting. The reviewers then issued a draft findings report, and we provided responses and a proposed action plan on the findings.

Finally, we received the finalised QAP report from The Malaysian Institute of Certified Public Accountants (MICPA).

**What is your view on the overall process of QAP? In your opinion, is there any area where the QAP could be further improved?**

**KS Chia & Associates:** We find that the process of QAP is fast and straightforward. The whole process does not disrupt the firm's operation. Regardless, we thought it would be more meaningful if the reviewer gave us a rating based on the findings after the QAP, on whether our firm is up to the mark or otherwise.

**Steven Lim & Associates:** It would be better if samples or templates to assist firms in improving audit quality can be provided upon conclusion of the assessment.

**What were your expectations when you signed up for the QAP?**

**KS Chia & Associates:** We expected an action plan that we could implement based on the reviewers' suggestions in the final QAP report and not to continue with the mistakes we used to make when performing the audit.

**Steven Lim & Associates:** We were looking forward to having a better understanding of our internal weaknesses and look at ways for improvement.

**In your experience, do you consider the programme value for money?**

**KS Chia & Associates:** Yes, it is value for money. We have learnt a lot during this QAP. It is very practical and points out specifically the weaknesses and what areas to be improved in our firm's practice.

**Steven Lim & Associates:** Yes, it is worthwhile for the firm.

**What was your main take-away from the programme?**

We need to enhance the audit fieldwork process and to improve on documentation of the audit findings.

**In what way do you think the QAP will help you in your future audit?**

**KS Chia & Associates:** We will put more emphasis on the quality of the audit engagement and not repeat the same mistakes made before participating in the QAP.

**Steven Lim & Associates:** We could further improve the quality of our firm in terms of audit quality and also audit staff.

**Would you recommend that other SMPs participate in the QAP?**

Certainly. Audit quality is fundamental to maintaining public trust in the capital markets and protecting investors. It is a key measure on which our professional reputation stands.

**KS Chia & Associates:** In addition, we have suggested to our other associated firms and acquaintances to sign up for the QAP.

**Do you expect to enrol in the follow-up review in the near future?**

Yes. We plan to enrol for the QAP again in the near future in our pursuit for continuous improvement in our firm audit quality.

**Following the effective date of ISQM1, ISQM2 and ISA 220 (Revised), do you foresee the firm will be enrolling into this QAP again?**

Yes. Our ISQC 1's manual was already reviewed in the previous QAP, and now we look forward for our System of Quality Management to be reviewed too.

**In your opinion, do you think that QAP is a good way to assess audit quality of an audit firm before the Practice Review? If yes, why?**

**KS Chia & Associates:** Yes. The QAP will provide the audit firm with the findings and proposed remedial action plans for implementation. The remedial action plan if executed well surely will improve the audit firm's audit quality and thus, there will be less hassle when Practice Review takes place.

**Steven Lim & Associates:** Yes, because QAP is a good assessment programme which can help us to identify our weaknesses, so that we can find ways to improve the audit quality in our firm.

## About the QAP

The QAP is an initiative to enhance audit quality among SMPs. A joint collaboration between MIA and MICPA since the QAP agreement was first signed on 25 October 2016, the QAP signals MIA and MICPA's commitment towards continuous improvement in the audit quality of SMPs in Malaysia.

## How the QAP Works

The QAP is a structured review of a MIA member firm by reviewer(s) appointed by MICPA. The review of the whole firm will comprise two parts:

- A review of the firm's compliance with the International Standard of Quality Control (ISQC) 1*, and;
- A review of the documentation of at least one completed audit engagement.

Participation in the QAP by SMPs is on a voluntary basis and designed to be educational in nature. The review will be conducted at the firms' premises. At the end of the review period, the QAP reviewer(s) will provide a report on the findings and the reviewed firm will provide the proposed remedial action plans for implementation.

**Currently in the midst of including the review of System of Quality Management following the ISQM 1 which has become effective on 15 December 2022. The review of ISQM 1 is expected to be rolled out in*

*Quarter 4 of 2023.*

## Objectives of the QAP

The QAP is designed to promote continuous improvement in audit quality in Malaysia.

It aims to assist audit firms in assessing compliance with the applicable auditing standards and MIA By-Laws in relation to audit engagements on financial statements prepared in accordance with the applicable approved accounting standards and the Companies Act 2016.

## QAP Fee

The maximum fee for participation in the Quality Assessment Programme (QAP) has been reduced from RM10,000 to RM6,000 since August 2022 and will be valid until 30 June 2024. The maximum fee excludes out-of-pocket disbursements and Sales and Services Tax.

Please seize the opportunity to participate in the QAP at a reduced fee while it is still offered at this rate.

Firms that have participated in the QAP before are encouraged to request for follow-up to assess the execution of any remediation action plans as agreed with the QAP reviewers in the previous QAP.

## Interested to participate?

SMPs (not registered with the Audit Oversight Board) that are interested to participate in the QAP are required to complete the Practice Profile Information Questionnaire by clicking here and forwarding the same to the SMP Department at smp@mia.org.my. The questionnaire will enable the QAP reviewer(s) to understand your practice better.

Effective April 2023, firms that have participated in the QAP will be given time for quality improvement and will not be selected for MIA Practice Review at least within the 24 months after the completion of the QAP, provided the whole process (starting from the audit firm's enrolment to QAP Programme) does not exceed 36 months. The completion date of the QAP will be the date of the final report issued to participating firms. *(Note: Under normal circumstances, QAP participating firms will not be selected for practice review by MIA during the 24-month improvement period, except for firms referred by other regulators for inspection/investigation/disciplinary action)*

Audit firms that are currently under MIA Practice Review or have been notified for MIA Practice Review are not allowed to participate in the QAP until the Practice Review process is completed.

Testimonials from participating firms, detailed processes, charges, common findings of the QAP and the comparison between practice review and the QAP can be found in the following articles published in e-AT:

- Thumbs up for QAP
- Everything you need to know about QAP

- Quality Assessment Programme: Common Findings of the Firm-level and Engagement-level Review

# Transfer Pricing Characterisation – Why does it matter? (Republished)

at-mia.my/2023/05/03/transfer-pricing-characterisation-why-does-it-matter-republished
May 3, 2023

*By Gagandeep Nagpal and Thomas Chan Yeu Wai*

The risk-reward theory in economics states that higher the risk, higher the return. This principle of economics is also used in transfer pricing (TP) to determine the arm's length compensation of the transacting parties. It means the transacting entity who takes relatively more risk in any business arrangement vis-à-vis its counterparty would be expected to have relatively higher returns (actual/expected) under TP principles. Therefore, it is critical to define the precise risk profile of the transacting parties, as TP compensation for any transaction would be determined accordingly. In TP jargon, the risk profile of the entity is reflected through a few commonly used phrases, which we generally refer to as TP characterisation.

In this context, it is worth discussing certain latest amendments to the Year of Assessment (YA) 2022 Form C, which requires significant additional TP disclosures (as per Item F8). One of the main TP disclosures in this updated Form relates to TP characterisation, which hints at an increasing reliance by the Inland Revenue Board of Malaysia (IRBM) upon information about TP characterisation to perform risk-based selection of audit cases. As such, we will examine the important aspects of TP characterisation in the subsequent paragraphs.

## TP characterisation is the foundation of arm's length analysis

One of the building blocks of any TP analysis is the functions, assets, and risks (FAR) analysis, wherein the functions performed, assets deployed, and risks assumed by the transacting parties are analysed. TP characterisation is basically an outcome of FAR analysis which sums up the entire functions, assets, and risk analysis in a defined short phrase. It further lays the foundation of economic analysis viz. selection of the most appropriate TP method, profit level indicator, selection of tested party and comparable companies.

Malaysia TP Guidelines (the Guidelines) have also recognised the TP characterisation as an important step towards determination of arm's length price of the controlled transaction. The Guidelines also talk about characterisation based on the nature of activity and complexity of the operations. The most commonly used transfer pricing characterisation based on the nature of the business activities is listed below:

| MANUFACTURING PROFILE ENTITIES | DISTRIBUTOR PROFILE ENTITIES | SERVICE PROVIDER PROFILE ENTITIES |
|---|---|---|
| • Full-fledged/licensed manufacturer<br>• Routine manufacturer<br>• Contract manufacturer<br>• Toll manufacturer | • Full-fledged distributor<br>• Routine distributor<br>• Limited risk distributor<br>• Commissionaire/agent | • Full-fledged service provider<br>• Routine service provider<br>• Limited risk service provider |

Kindly note that there could be a situation wherein the profile of the transacting parties may not fit exactly into any of the above water-tight compartments of TP characterisation – i.e. hybrid situations.

## Approach to determine the right TP characterisation

After discussing the relevance of TP characterisation, the next obvious question is how to determine the right TP characterisation in relation to the business activities carried out by the transacting parties. As a matter of caution, it would be a risky proposition to determine TP characterisation without conducting a FAR analysis. FAR analysis not only indicates which transacting party is assuming economically significant risks arising from the transaction, but also functions performed and assets deployed by transacting parties to manage and control those economically significant risks. To illustrate the relevance of FAR analysis in determination of TP characterisation, the following case study would be useful.

`Case study -   A Malaysian entity manufactures and sells goods entirely to its related party in Singapore. The Singapore entity is`

| | SCENARIO 1 | | SCENARIO 2 | |
|---|---|---|---|---|
| | Malaysia Co | Singapore Co | Malaysia Co | Singapore Co |
| Market /Price strategy and related market risk | ✓ | - | - | ✓ |
| Production activities and related risk | ✓ | - | ✓ | - |
| Marketing intangibles | ✓ | - | - | ✓ |
| **TP Characterisation** | **Full-fledged manufacture** | **Limited/Routine risk distributor** | **Contract/ Routine manufacturer** | **Full-fledged distributor** |

The above FAR analysis (although not comprehensive for the sake of brevity) reflects how this analysis could have an impact on TP characterisation of both Malaysia and Singapore entities.

## Common disputes around TP Characterisation

Based on recent TP audit trends, some common disputes by the IRBM around TP characterisation were:

##### Determination of arm's length compensation

As mentioned above, TP characterisation lays the foundation of economic analysis. Therefore, any incorrect declaration about TP characterisation could give a wrong impression to the tax authorities about the risk profile and accordingly could lead to a situation wherein the IRBM may expect particular type of compensation for the taxpayer. In order to illustrate it better, we have laid out below two illustrative scenarios (not exhaustive) –

- In the first scenario, a Malaysian taxpayer declares that it is a full-fledged manufacturer (selling to a related party limited risk foreign trading arm). In such a case, the IRBM would expect that the transaction pricing should be such that the trading arm only gets a routine return, and the residual profit should be attributed to the Malaysian taxpayer.
- In the second scenario, a Malaysian taxpayer characterises its business as a limited risk distributor (buying from a risk-bearing foreign related party manufacturer). In such a case, the IRBM would expect that the local taxpayer should be entitled to an assured routine return, generally irrespective of market situations. During the pandemic, it was a moot question debated by many limited risk entities.

Further, TP characterisation could have a bearing on the selection of TP method. For instance, the IRBM may expect a taxpayer with the characterisation of a full-fledged manufacturer to apply the profit split method instead of the transactional net margin method, if the foreign counterparty is sharing certain economically significant risks with said manufacturer. In other cases, the dispute could also be on the selection of the tested party or the profit level indicator, and most commonly the selection of comparable companies.

##### Performance of economic adjustments

A taxpayer may perform certain economic adjustments in case its financial performance in any particular year was impacted by abnormal business factors. However, the IRBM considers such economic adjustments on a case-by-case basis after evaluating the TP characterisation of the entity. For example, in case the taxpayer is a limited risk entity, then the IRBM may not recognise any economic adjustments to improve the operating results and may expect that limited risk entity to get an assured routine compensation from the risk-bearing counterparty.

##### Business restructuring

If there is any change in TP characterisation, it may be viewed as a case of business restructuring and any business restructuring would come with its own set of consequential TP issues. In particular, if a change in business characterisation has an impact on the profit potential, then it attracts attention from the IRBM and could be challenged if there is no change in the functions performed, the assets deployed, or the risks assumed, pre and post restructuring, based on the conduct of the parties.

In fact, information about business restructuring is another set of particulars sought by the IRBM in the updated Form C that applies to YA 2022. Therefore, these particulars need to be filled in carefully.

##### Significant advertisement, marketing and promotion expenses

The IRBM also tends to challenge the TP characterisation of limited risk and routine distributors, if the IRBM determines that the local entity is involved in significant local advertisement, marketing, and promotion activities, usually reflected through high local expenditure on these activities. As a consequence, the IRBM may expect additional compensation in the form of reduced royalty (or discount on purchase price) or cost-plus compensation treating it as a separate service over and above routine distribution activities or consider only comparable companies having a similar level of advertisement, marketing and promotion expenses. In certain cases, the IRBM may go into the realms of profit split method as well.

The above examples are not exhaustive in terms of the potential areas of dispute relating to TP characterisation, but these at least provide a sense of how critical the issue of TP characterisation is.

## Way forward

With the introduction of the updated YA 2022 Form C on TP disclosures involving business characterisation, it is important that the taxpayer is characterised accurately, with reference to the FAR analysis. Taxpayers eligible to prepare minimum transfer pricing documentation (without FAR analysis) especially should exercise care in providing the declaration about TP characterisation. An incorrect declaration regarding TP characterisation could have significant implications during an audit.

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# Transfer Pricing Recharacterisation – Exploring the unexplored aspects

**at-mia.my**/2023/05/24/transfer-pricing-recharacterisation-exploring-the-unexplored-aspects
May 24, 2023

*By Gagandeep Nagpal and Himanshu Bakshi*

**Where do we draw a line?**

It is always debated as whether the tax authorities in the garb of transfer pricing can obligate taxpayers to maximise their local profitability in hindsight, by stepping into their shoes to see how a prudent businessman would act in the given facts and circumstances. Over the course of time, the bar seems to have been lowered for tax authorities to challenge commercial expediency on transfer pricing matters. In recent transfer pricing audits, the tax authorities are increasingly questioning the commercial rationality of the business arrangement/transactions, over and above the transaction pricing. One may argue that the commercial expediency depends upon the commercial wisdom of the taxpayer and the tax authorities cannot decide what is commercially expedient for the taxpayer. However, the tax authorities are certainly not precluded from assuming powers against those who attempt to circumvent the law through unacceptable and prohibited means. Therefore, the question arises as to where we draw the line between such power of tax authorities and the commercial expediency of the taxpayer.

**Do we have a relevant framework?**

It is relevant to refer to Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines, which assist to provide some guiding principles around this. The OECD has always recommended to respect the transaction as structured by the taxpayer, with two key exceptions, wherein, a business arrangement or transaction could be recharacterized.

First, where a form of the transaction is different from the *"**commercial substance**"* (by analyzing the conduct of the parties) and;

Second, where form and substance are the same but the transaction/arrangement, viewed in totality, lacks "***commercial rationality*"** and a transaction is structured such that it would hinder the determination of arm's length price.

Further, the OECD also clarified that a transaction should not be recharacterised or disregarded just because a transaction/arrangement like one entered by a taxpayer with its group of companies is not found in the open market between third parties. Restructuring legitimate business transactions would be a wholly arbitrary exercise, the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. Current OECD TP Guidelines do not specifically mention the word "recharacterisation" and simply focus on "disregarding" or "non-recognition".

Interestingly, the revised OECD TP Guidelines post BEPS 1.0 refers to only one of the above conditions (instead of two circumstances mentioned in earlier versions of OECD TP Guidelines), i.e., a transaction/arrangement lacking commercial rationality may qualify for non-recognition or to be disregarded. The only explanation seemingly, though not reflected in the current OECD TP Guidelines, for such a change is that the current OECD TP Guidelines focus on the "delineation" of controlled transactions, and that already addresses the issue of commercial substance.

Delineation means lifting the veil or to understand the real deal in the transaction. The delineation process does not merely go by the form of the transaction as represented in an inter-company contract but focuses on "commercial substance". The implication of subsuming the "substance over form test" in the delineation process is that it allows tax authorities significant discretionary power and latitude to recharacterize the transaction structure under the garb of delineation.

**What is the situation outside?**

While there is a plethora of transfer pricing controversies arising out of the issue of recharacterisation across countries, we have attempted to cover the key recent ones which made interesting observations on this issue.

In the case of *Glencore Investment Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia [2019] FCA 1432,* the Court held that any reconstruction should be limited to the exceptional circumstances referred to in the OECD guidelines. The terms of an agreement cannot be reconstructed to conduct the comparative analysis and must generally respect the actual transaction entered into between the parties.

In *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2017] FCAFC 62,* the Court concluded that a taxpayer cannot write the terms of its loan arrangements with related parties (e.g. to exclude security or a guarantee) and then determine the arm's length price according to those terms.

In *Canada v. Cameco Corporation (2020 FCA 112),* the Supreme Court of Canada affirmed the decision of the Federal Court of Appeal which concluded that the recharacterisation provision in the Income Tax Act does not (and is not intended to) prevent MNEs from organizing their activities in a way different from what would be found in entirely arm's-length circumstances, so long as these situations are priced in accordance with the arm's-length standard.

In the case of *UK vs BlackRock, July 2022, Upper Tribunal, Case No [2022] UKUT 00199 (TCC), o*verruling the conclusion of the First Tier Tribunal, the Upper Tribunal mentioned that the loan arrangement was put in place with both commercial purpose as well as tax advantage purpose, but for the tax advantage purpose, there would have been no commercial purpose to the loan.

There are many similar interesting case laws on this issue in other jurisdictions as well, especially in relation to inter-company financing and business restructuring. Largely, OECD guidance is being followed to decide on these matters.

**Where does Malaysia stand?**

After doing a bit of a world tour, let us come back to Malaysia and try to understand what is happening locally regarding this issue. Let us first understand the regulatory framework on this subject matter. Malaysia had an interesting start on transfer pricing as prior to 1 January 2009, there was no specific statutory provision in the Malaysia Income Tax Act ('ITA') governing transfer pricing matters. The Inland Revenue Board of Malaysia ('IRB') had often invoked Section 140 of the ITA for the years before 2009, a general anti-avoidance provision, to undertake transfer pricing adjustments on transactions not considered to be at arm's length. In 2009, a specific provision of transfer pricing was enacted via the insertion of Section 140A, which however provided the Director General of Internal Revenue (DGIR) with the power to only substitute prices and disallow interest deductions on certain transactions not considered to be at arm's length. Therefore, starting with the wider and most powerful provision of general anti-avoidance to regulate transfer pricing, the power seemed to be limited by Section 140A. Although the Malaysia Transfer Pricing Rules of 2012 later empowered the DGIR to recharacterise the transactions in similar situations as prescribed by OECD, however, the Rules cannot stretch the powers emanating from the provisions of the ITA. Realising this legal limitation in invoking the recharacterisation provision, the IRB amended Section 140A and incorporated the recharacterisation provision within the provision of ITA itself effective from January 1, 2021.


In terms of dispute and controversy on this issue, Malaysia's transfer pricing environment is not isolated. The IRB has been actively invoking recharacterisation provisions primarily in respect of the issues like interest-free advances recharacterised as loans or vice-versa; de-recognition of certain business restructuring; and transactions relating to intangibles, etc. A few cases have already traveled to the Court on this issue, like the case of Malaysia Vs Shell Shared Services Asia Sdn Bhd, wherein the IRB recharacterised the arrangement as intra-group services instead of a cost-contribution arrangement; however, the matter was eventually set aside by the High Court more on procedural grounds rather than on merits.

**How can taxpayers mitigate recharacterisation risk?**

Considering the business dynamics in today's world and Malaysia being the go-to destination for various MNEs for expanding their business operations, various restructuring activities are evident on the ground. During transfer pricing audits, it is observed that the IRB has questioned the taxpayers by way of issuing detailed questionnaires to understand the underlying rationale of transactions. If there are no relevant documents available to be placed on record i.e., comprehensive transfer pricing documentation, transfer pricing group policy aligned to agreements, board resolutions, etc., else it can be a challenge for the taxpayer to put up a veritable defence against any recharacterisation attempt by the IRB. From a taxpayer perspective, it is important to follow a proactive approach on the following lines to mitigate the recharacterisation risk:

- Perform accurate delineation of the business arrangement/ transactions as per the revised standards of transfer pricing in the following manner –
    - The taxpayer needs to consider whether the written contractual terms are commercially feasible and realistic. If a similar arrangement was to be entered into between third parties, consider whether additional terms would be incorporated or vice versa.
    - Critically evaluate the location of the economic activities and avoid possible mismatch with the intercompany agreement. Any loose terms in an inter-company agreement may result in deviation from the actual conduct and may elevate the risk.
    - Identify the economically significant risk of the business arrangement/transaction and apply the risk control framework in performing functions, assets, and risk analysis as per the OECD and the Malaysian Transfer Pricing Guidelines.

- The transfer pricing documentation should include the delineation process, business rationale, relevant economic circumstances, and business strategy, before performing any benchmarking analysis. Preferably, transfer pricing documentation should be prepared on an ex-ante basis, rather than on an ex-post basis.
- A few additional analyses (as referred below) in respect of certain transactions which are often at risk of recharacterisation are –

| NATURE OF TRANSACTION | RELEVANT ANALYSIS |
|---|---|
| Intangibles related transaction | Analysis of Development, enhancement, maintenance, protection, and exploitation activities ('DEMPE' analysis) in regard to the intangibles, so that legal and economic ownership can be aligned, leading to proper attribution of arm's length compensation. Similarly, the documentation of underlying assumptions taken at the time of pricing of hard-to-value intangibles would assist in defending any hindsight questioning. |
| Intra-group services | Proper framework to carve out shareholder activities, duplicative activities, determination of cost-base, appropriate allocation keys, benefit test documentation assist to defend any subjective questioning. This analysis should be performed over and above justification of the arm's length pricing of the transactions. |
| Financing transactions | Proper framework in defining interest rates considering debt capacity of the borrower, options realistically available to both lender and borrower, other factors defining nature of instrument (fixed/floating, secured/unsecured, currency, tenure, repayment terms etc). |
| Business restructuring | Documentation of commercial rationale for undertaking business restructuring, pre and post restructuring functional analysis which eventually assists in determining the compensation for restructuring itself and post-restructuring compensation for a restructured entity. |

** The above are indicative and not exhaustive; these merely stress the need for relevant analysis and documentation in the context of different types of transactions.*

**In the end**

There is an increasing realisation amongst tax authorities, that transfer pricing provisions (even after incorporating stringent BEPS 1.0 standards) are losing teeth and provide limited assistance in collecting their fair share of taxes. Therefore, along with the implementation of BEPS 2.0 measures, the frequent invocation of recharacterisation provisions by tax authorities may continue as a trend. Taxpayers should be ready with the relevant analysis and the right amount of documentation to defend any recharacterisation challenges.

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*The content in this article are the personal views of the authors and does not purport to reflect the views of Deloitte Malaysia.*

# Understanding Arm’s Length Interest Deduction

at-mia.my/2023/05/30/understanding-arms-length-interest-deduction
May 30, 2023

*By S. Saravana Kumar and Nur Amira Ahmad Azhar*

Many multinational enterprises (**MNEs**) frequently rely on external borrowings to support their operations. MNEs have various borrowing arrangements between the enterprises within the group. As such, the restriction on deductibility of interest under Section 140C of the Income Tax Act 1967 (**ITA**), Income Tax (Restriction on Deductibility of Interest) Rules 2019 (**2019 Rules**) and Income Tax (Restriction on Deductibility of Interest) (Amendment) Rules 2022 (**2022 Rules**) have been introduced to restrict deductions for interest expense or any other payments which are economically equivalent to interest, to ensure that such expenses commensurate with the business income. The 2019 Rules was introduced into the ITA to implement the Earning Stripping Rules (**ESR**). The Restriction on Deductibility of Interest Guidelines (**Restriction Guidelines**) was issued to provide clarification on the Rules.

As the legislation is based on Base Erosion and Profit Shifting (**BEPS**) Action 4 of the Organisation for Economic Cooperation and Development (**OECD**), the Restriction on Deductibility of Interest Rules (ESR) is intended to prevent base erosion through the use of excessive interest expense or any payment which are economically equivalent to interest via controlled financial assistance.

## What is the Arms-Length Interest Deduction?

The Arms-Length Interest Deduction (**ALID**) is a transfer pricing principle that is used to determine the appropriate level of interest that can be charged between related entities. This principle is based on the concept that transactions between related entities should be conducted on the same terms and conditions as transactions between independent parties (i.e. at arm’s length).

The ALID rule is intended to prevent base erosion through the use of excessive interest expenses or any payments which are economically equivalent to interest. This means that MNEs cannot use their intra-group financing arrangements to reduce their taxable profits by artificially inflating interest expenses.

## Implementation of the ALID in Malaysia

The 2019 Rules was gazetted on 28 June 2019 concerning Section 140C of the ITA, which was introduced into the ITA to implement the ESR.

The legislation restricts the interest expenses or payments economically equivalent to interest that can be deducted by specified persons who have been granted financial assistance in a controlled transaction. This means that MNEs must ensure that their intra-group financing arrangements comply with the ALID rule.

To comply with the ALID rule, MNEs must ensure that their financing arrangements are based on commercial terms and conditions. This means that the interest rate and other terms of the loan should be consistent with what would be offered to an independent third party in a similar transaction.

MNEs must also maintain appropriate documentation to support their financing arrangements. This includes records of the terms and conditions of the financing arrangements, the creditworthiness of the borrower, and any other relevant factors that would be considered in a similar transaction between independent parties.

## Controlled Transactions

As stated above, the interest restriction only applies to related parties. The definition of "control" under Section 140C(3) of the ITA is defined under Section 140A(5A) of the ITA. It refers to situations where one person owns shares in another person or where a third person owns shares in both persons, and the percentage of share capital held in either situation is 20% or more. Additionally, the business operations of the person receiving financial assistance or engaging in a controlled transaction must depend on proprietary rights provided by the other person or a third person, or their business activities must be specified by the other person, and the prices and conditions relating to the supply must be influenced by such other person or a third person. In some cases, one or more of the directors or members of the board of directors of a person may be appointed by the other person or a third person.

Further, a "controlled transaction" is construed as financial assistance between persons where one person has control over the other, or both persons are controlled by some other person. These provisions aim to prevent tax avoidance and ensure that interest expenses are deductible only in situations where they are genuinely incurred and reflect arm's length transactions.

## Restriction on Interest Expense

The ITA imposes restrictions on the deductibility of interest expenses for certain transactions under Section 140C. Section 140C(3) of the ITA defines interest expense as interest on all forms of debts or payments economically equivalent to interest (excluding expenses incurred in connection with the raising of finance). On the other hand, financial assistance in a controlled transaction is defined under Section 140C(3) of the ITA 1967 to include loans, interest-bearing trade credit, debt, advances, or the provision of any security or guarantee.

According to Section 140C(2) of the ITA, interest expenses incurred in connection with financial assistance or controlled transactions granted directly or indirectly to a person that exceeds the maximum amount of interest as determined under the Act cannot be deducted from the gross income when calculating adjusted income.

Essentially, the ITA restricts the interest expenses or payments economically equivalent to interest that can be deducted by specified persons who have been granted financial assistance in a controlled transaction.

The Earning Stripping Rules Guidelines 2022 (**ESR Guidelines**) provide a more detailed definition of interest, stating that it is the return or compensation for the use or retention by a person of a sum of money belonging to or owed to another person. The ESR Guidelines also exclude interest expense incurred in connection with the raising of finance (guarantee fee) or not allowable in ascertaining the adjusted income under the ITA before any restriction on the deductibility of interest is made under Section 140C of the ITA of a person from the business source.

The IRB issued a Restriction on Deductibility of Interest Guidelines (**Guidelines**) to shed light on the applicability of Section 140C of the ITA and the 2019 and 2022 Rules (**Legislations**). The Guidelines state that the Legislations apply to all persons within the charge to tax under the Act, except certain categories of persons excluded in the 2019 and 2022 Rules.

The Guidelines apply to any person who has interest expense from financial assistance, which is deducted before the restriction on the deduction of interest is made under Section 140C of the ITA. This interest may be accrued, paid, or payable and due to be paid to the person's associated person outside Malaysia or to a third party outside Malaysia, where the financial assistance is guaranteed by its holding company or any other enterprises under the same MNE Group. This ensures that taxpayers do not artificially shift profits to low-tax jurisdictions by paying excessive interest to related parties.

Furthermore, the guidelines include a de minimis threshold of RM500,000. The interest restriction under Section 140C of the ITA does not apply to a person where the total amount of any interest expense for all financial assistance from all business sources is equal to or less than RM500,000. It is essential to note that the threshold of RM500,000 should be accumulated from all business sources, and the calculation of interest restriction should be made separately on each business source in case a person has multiple business sources.

Another critical aspect of the guidelines is the calculation of Tax-EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization) to determine the maximum amount of interest deduction that a taxpayer can claim. Negative Tax-EBITDA will be considered as NIL, and any interest payment, which is not due to be paid in a particular year of assessment, would have been excluded in arriving at the adjusted income, part [A] under the tax-EBITDA formula for that year of assessment. However, when the interest is due to be paid, the assessment for that year of assessment will be revised by the taxpayer to allow a deduction of interest under Section 33(5) of the ITA. This provision ensures that interest expenses incurred by taxpayers are appropriately reflected in their tax returns.

# Determining Arm's Length Interest Rate

In determining the arm's length interest rate and accurately delineating the transaction, the IRB has stated that taxpayers are to refer to the OECD guidelines. The OECD recommends an analysis of the factors affecting the performance of the businesses in the industry sector in which the relevant MNE group operates such as the particular point of an economic, business or product cycle, the effect of government regulations, or the availability of financial resources in a given industry. MNE groups require different amounts and types of financing due to varying capital intensity levels between industries; they also require different levels of short-term cash balances due to differing commercial needs between industries.

Where the relevant MNEs are regulated, i.e. financial services entities subject to regulations consistent with recognised industry standards, the constraints the regulations imposed upon them must be given due consideration. Financial services businesses are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured and disclosed. Thus, the regulatory approach to risk allocation for regulated entities, i.e. the transfer pricing guidance specific to financial services businesses released previously should be considered and referenced where applicable.

Identifying the material risks assumed by each related party in such circumstances is required for a complete functional analysis of such factors. The actual assumption of risk by the parties would influence the prices and other conditions of transactions between the associated enterprises. Within an open market, the assumption of increased risk would be compensated by an increase in the expected returns, even though the actual return is dependent on the actual realisation of risk and may not increase. Risk is inherent where business takes place, and identifying risks goes hand in hand with identifying functions and assets.

In drawing a comparison between controlled and uncontrolled transactions, it is necessary to determine what risks have been assumed to determine the profit potential of the opportunity in the open market and how profits or losses resulting from the transaction are allocated at arm's length through the pricing of the transaction. The 2022 Guidelines provide a step-by-step approach to accurately delineating the actual transaction concerning that risk.

The process of accurate delineation of the actual transaction also requires an understanding of how the particular MNE group responds to those identified factors. For instance, how the MNE group prioritises the funding needs among different projects, the strategic significance of a particular MNE within the MNE group, whether the MNE group is targeting a specific credit rating or debt-equity ratio and whether the MNE group is adopting a different funding strategy than the one observed in its industry sector.

Accurate delineation of the actual transaction should begin with a thorough identification of the economically relevant characteristics of the transaction – consisting of the commercial/financial relations between the parties and the conditions, economically relevant circumstances attaching to those relations – including an examination of the contractual terms of the transaction, the functions performed, assets used, risks assumed, characteristics of the financial instruments, economic circumstances of the parties and the market, and the business strategies pursued by the parties.

In applying the arm's length principle to a financial transaction, it is also necessary to consider the conditions that independent parties would have agreed to in comparable or similar circumstances. Independent enterprises, when considering whether to enter into a particular financial transaction, will consider all other realistically available options. They will only enter into the transaction if they see no alternative that offers a more attractive opportunity to meet their commercial objectives. In other words, they will only enter into a transaction if it is not expected to render them worse off than their next available option.

In considering the options realistically available, the perspective of each party to the transaction must be considered. For example, where the entity advances funds, other investment opportunities may be contemplated, considering the specific business objectives of the lender and the context in which a transaction takes place. From the borrower's perspective, the realistically available options would include broader considerations than the entity's ability to service its debt, such as the funds it actually needs to meet its operational requirements. In some instances, although an entity may have the capacity to borrow and service an additional amount of debt, it may choose not to do so to avoid placing negative pressure on its credit rating and increasing its cost of capital, and risk jeopardising its access to capital markets and its market reputation.

When seeking to price the accurately delineated actual transaction, the economically relevant characteristics must be considered.

- For example, the contractual arrangements between associated enterprises do not always have a written agreement, and where there is such an agreement, may not be consistent with the actual conduct between the parties. In contrast, where financial transactions occur between independent enterprises the terms and conditions will be explicitly stated in a written agreement and adhered to as such. Thus, in determining whether the transaction is at arm's length it is necessary to look at the contracts between the parties as well as the actual conduct, and the economic principles that generally govern relationships between independent enterprises in comparable circumstances.

- A functional analysis of the controlled transaction is also necessary. Such an analysis entails identifying the functions performed, the assets used and the risks assumed by the parties. As an example, the lender in an intra-group loan in deciding whether and under which terms to advance funds would evaluate the inherent risks, the capability to commit capital of the business to the investment and the organisation and documentation of the loan. Such a functional analysis would likely include consideration of similar information, such as what a commercial lender or rating agency would consider in determining the creditworthiness of a borrower. A lender in an intra-group loan would not perform their functions at the same intensity as an independent lender. From the perspective of the borrower, functions that would be considered are the definite availability of funds to repay principal and interest on the loan when due, the capacity to provide collateral if needed, and the ability to fulfil any other obligations deriving from the loan contract.

- In the open market, the varying features and attributes of financial instruments affect the pricing of these products and services. In comparison where a controlled transaction occurs, the transaction's features and attributes similarly play a part in affecting its arm's length pricing as a financial instrument. An example of such attributes in the case of a loan would be the amount of the loan, its maturity, the schedule of repayment, its nature or purpose, the geographical location of the borrower, collateral provided, the presence and quality of any guarantee and whether the interest rate is fixed or floating.

- In achieving comparability, the markets in which the independent and associated enterprises operate will not have differences that have a material effect on the price, or appropriate adjustments can be made to achieve this effect. Underlying economic circumstances in the open market such as different currency rates, geographic location, local regulations, the timing of the transaction and the business sector of the borrower can affect the price of financial instruments, including loans. Economic factors such as the growth rate, inflation rate and volatility of exchange rates mean that otherwise similar financial instruments issued in different currencies may have different prices. Prices for financial instruments in the same currency may vary across jurisdictions due to local regulations such as interest rate controls, exchange rate controls and foreign exchange restrictions.

Further, macroeconomic trends can also affect prices. These include central bank lending rates, interbank reference rates, and financial market events such as a credit crisis. Therefore, the precise timing of when a financial instrument is issued in the primary market or the selection of comparable data in the secondary market can be significant in terms of comparability. For example, the closer in time a comparable loan issuance is to the issuance of the controlled loan, the less likely that different economic factors will prevail as a factor. Nonetheless, it remains possible for particular events to cause rapid changes in lending markets, reducing comparability between both transactions.

The business strategies of the enterprise must be examined in accurately delineating the actual financial transaction and in determining the comparability of controlled and uncontrolled transactions and enterprises. This is relevant as business strategies affect the terms and conditions of loan agreements between enterprises. Business strategies take into account aspects such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, the input of existing and planned labour laws, duration of arrangements and other factors bearing upon the daily conduct of business. An examination of business strategies would also entail consideration of the MNE group's global financing policy, and the identification of existing relationships between the associated enterprises such as pre-existing loans and shareholder interests.

## Penalties for non-compliance

Non-compliance with the ALID rule can result in penalties, including disallowance of interest expenses and additional tax assessments. There is no penalty provision specific to Section 140C within the scope of applicable financial transactions. However, where deliberate tax avoidance has been established and the Director General of Inland Revenue (**DGIR**) elects not to prosecute, Section 113(2) of the ITA allows the DGIR to impose a penalty equal to the amount of tax that has been undercharged in consequence of the incorrect return or incorrect information on the person. Unless the DGIR chooses to exercise his discretion under Section 140(1) of the ITA to vary or disregard the transaction, the extent of the penalty under Section 113(2) of the ITA may reach up to 100% of the tax amount undercharged. Section 140(6) of the ITA expressly includes transfer pricing transactions as transactions subject to the jurisdiction of the DGIR under Section 140(1) of the ITA. MNEs must ensure that they comply with the ALID rule to avoid these penalties.

## Importance of TP Documentations

The arm's length principle is crucial to ensure that intercompany transactions are conducted on a fair and equitable basis. However, disagreements over what constitutes arm's length pricing can lead to disputes that are difficult to resolve. Therefore, it is crucial for taxpayers who conduct transactions between associated companies to maintain proper transfer pricing documentation. This documentation can help taxpayers demonstrate that their pricing is at arm's length, avoid disputes with tax authorities, and provide evidence of their compliance with transfer pricing regulations. Furthermore, it can help establish a transparent and consistent pricing policy across different jurisdictions, minimizing the risk of double taxation. Proper transfer pricing documentation is essential to ensure compliance with tax regulations and avoid unnecessary disputes with tax authorities.

Hence, the question of what constitutes arms-length pricing is often contentious and can lead to disputes that are difficult to resolve. The High Court case of ***Ketua Pengarah Hasil Dalam Negeri v Watsons Personal Care Stores*** **(WA-14-20-06/2020)** recently shed light on the importance of transfer pricing documents on both taxpayer and the Inland Revenue Board (**IRB**).

In this case, Watsons Personal Care Stores (**the Taxpayer**) borrowed sums of money via loans from Watson Labuan in the years 2003 and 2012 to finance the acquisition of shares in Watson Malaysia. The interest rate on the loans was to be paid at the rate of 3% plus the London Interbank Offered Rate (**LIBOR**) on a yearly basis, and the principal amount borrowed is to be paid on demand by Watson Labuan. The Director-General of Inland Revenue (**DGIR**) sought to adjust the interest rate under Section 140A of the Income Tax Act 1967 (**ITA**) and Rules 8(1)(b) and 8(2) of the Income Tax (Transfer Pricing) Rules 2012 (**TP Rules**) to 0% and disallow the deduction of interest paid by the taxpayer because the money borrowed was not an arm's length transaction.

The High Court held that Section 140A ITA does not give the DGIR the power to disregard/ignore any transactions. Instead, Section 140A requires the DGIR to substitute the price in respect of the transaction to reflect an arm's length price for the transaction where it has reasons to believe the transactions were not carried out at arm's length. In this regard, the DGIR did not make any adjustments to the structure of the loan transactions or substitute the interest rate for one that would have been expected between independent persons. The DGIR merely substituted the interest rate with 0% on the basis that no independent party would carry out such a transaction. Thus, the DGIR's failure to make any adjustments to the loans or substitute an arm's length rate is contrary to section 140A.

In deciding in favour of the taxpayer, the High Court highlighted the importance of a transfer pricing documentation as follows:

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| The Taxpayer's TP Documentation shows the basis and analysis of why the comparables were chosen. | The loans provided to the taxpayer are similar to that of an uncommitted facility typically offered by commercial banks whereby both a borrower/lender would have more flexibility on when to make/request a repayment of such debt. |
| The Court found that the DGIR did not put forward any evidence to refute the taxpayer's transfer pricing analysis, and accordingly, there was no basis on which the DGIR would have concluded that the interest charged is higher than what would have been agreed between independent persons. Thus, the DGIR's rejection amounted to a bare denial. | Once a TP Documentation is prepared, the DGIR must provide its basis, supported by facts and law, for rejecting the said TP Documentation. |
| The DGIR must provide its own transfer pricing report should it disagree with the taxpayer and the DGIR's failure to provide a TP Report and to support his position adopted with sufficient evidence showed that the DGIR acted unlawfully and wrongly. | The taxpayer's TP Documentation was demonstrated to comply with the TP Guidelines 2012 and in the absence of a contrary transfer pricing report prepared by the DGIR, the taxpayer's version must be accepted. |
| As there was no evidence from the DGIR to show that the taxpayer's TP Documentation was unreliable and in the absence of such evidence, the taxpayer had proved its case that the interest rate was arm's length. | Therefore, the taxpayer's TP Documentation should be maintained, and all adjustments made by the DGIR regarding transfer pricing against the taxpayer should be disregarded. |

## Conclusion

MNEs must ensure that their intra-group financing arrangements comply with the ALID rule to avoid penalties and ensure that their tax positions are in line with the legislation. By maintaining appropriate documentation and ensuring that their financing arrangements are based on commercial terms and conditions, MNEs can comply with the ALID rule and avoid any adverse tax consequences.

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# Valuing Synergies: One plus one is greater than two?

[at-mia.my/2023/06/22/valuing-synergies-one-plus-one-is-greater-than-two](at-mia.my/2023/06/22/valuing-synergies-one-plus-one-is-greater-than-two)
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*By Ng Boon Hui and Kerk Su Ngee*

Globally, mergers and acquisitions (M&A) continue to be highly sought-after corporate exercises. Despite the anticipation of a global recession, CEOs remain interested in deals, with 63% of them indicating that they will pursue a deal in the next 12 months, as highlighted in the EY 2023 CEO Outlook Survey.

A high-level study on public M&A transactions in Malaysia over the last six years reveals that most of the transactions have resulted in the recognition of goodwill. Goodwill, as explained in the Malaysian Financial Reporting Standards (MFRS) 138, is an asset representing the future economic benefits arising from other assets acquired, which may result from synergy with the identifiable assets acquired.

The study highlighted that approximately 40% of the transactions resulted in positive growth in market capitalisation after the M&A. However, various studies[1] show that 50% of the M&A transactions failed to achieve or realise the expected synergy. The Harvard Business Review[2] also reported that 70% to 90% of M&A fail during the post-merger integration phase.

While acquirers[3] envisage synergies post-M&A, the market has revealed that the realisation of synergistic value is complex. To begin with, acquirers expect an immediate increase in their business value from the M&A exercise. More often than not, they also anticipate a synergy to emerge subsequent to the M&A exercise. According to the International Valuation Standard (IVS), synergistic value is defined as:

> "The result of a combination of two or more assets or interests where the combined value is more than the sum of the separate values."

## Commonly identified synergies

Depending on the nature of the transaction and industry, the expected synergies may broadly be classified into two categories, namely, revenue synergies and operational synergies.

#### Revenue synergies

A key revenue synergy is the potential for cross-selling products to a wider customer base. This is observed in the acquisition of a premium Asian grocery store chain by a leading superapp company. Before the acquisition, the grocery store chain had a strong physical presence in the retail industry, while the leading superapp company had a competitive advantage in the ride-sharing digital space. The acquisition has since enabled the grocery store chain to reach out to a wider online customer base.

Cross-border M&A would also allow acquirers to quickly gain access into different geographical markets. For example, a European general insurance company is anticipating an improved global footprint via its recent acquisition of controlling stakes in various general and life insurance companies in Malaysia. With an enhanced global presence, the general insurance company is in a better position to meet the needs of their international clients and compete in the international market.

**Operational synergies**

Some M&As were led by operational synergies such as improved manufacturing efficiency, economies of scale, research and development collaboration, technology and platform sharing. For example, the merger of a regional car maker with a Chinese car manufacturer provided the regional car maker with advanced automotive technologies, a global supply chain network and advanced production techniques, resulting in reduced production costs, improved operational efficiency and enhanced product quality.With the sharing of expertise, resources and knowledge, this merger accelerated the development of new technologies and more innovative products supporting the car maker to remain competitive.

Another recent example is the merger of two leading regional telecommunication players. This merger aimed to leverage on combined economies of scale, productivity and efficiency gains to improve network operations. By sharing knowledge in the research and development of 5G, artificial intelligence (AI) and internet of things (IoT) technology, the merger paved the way significantly towards the growth of Malaysia's digital ecosystem. With streamlined operations and processes as well as the post-merger plan to expand and enhance its network coverage to reach out to a larger customer base, increased growth in revenue and profitability are anticipated in the longer term.

## Valuing synergies

Valuing synergies typically starts with understanding the business model of the entities involved in the M&A and their respective valuations on an "as-is" basis. The general valuation approaches include the income approach (discounted cash flow method), market approach (market multiples) and cost approach. The selection of the approach(es) to be adopted depends on various factors such as the characteristics of the target, availability of information and the nature of transactions. Generally, for income-generating entities, the income approach will be adopted as the primary approach and cross-checks will be performed using either the market approach or the cost approach, depending on the nature and characteristics of the target company's business.

Next, a comprehensive understanding of the business model will lead to the identification of areas with potential synergistic opportunities. The synergistic opportunities identified will then be evaluated[4] in terms of the benefits, achievability, time frame and cost to realize the synergies. With the quantification of the evaluated synergies and revenue-related synergies, estimates are required to be made on the additional revenue to be generated from the cross-selling of products and the gaining of access to different geographical markets over a reasonable period of time. For operational synergies, estimates are required to be made on the potential cost savings from the integration of operations over a reasonable period of time. For the valuation to be meaningful, these synergies have to impact the profit or loss and cash flows of the businesses. The expected gains or losses from the identified synergies are then estimated using the risk adjusted net present value approach.

It is pertinent to note that the valuation of synergies is critically exacting, and it should be carried out as realistically as possible. Three often overlooked areas are:

| **Timing** | **Cost to counter de-synergies** | **Risk in the estimation of synergies** |
|---|---|---|
| The execution of the plan to realise synergies may take time for their effect to take place. Moreover, the durability of synergies is evolving as competitors can imitate the new strategy or product(s) in the long-term. Hence, the valuation of synergies needs to avoid over-optimism in estimating the timings to realise the anticipated synergies | Estimate foreseeable costs such as severance pay to eliminate the duplication of roles, organisation and IT systems integration costs, and the potential | As the process of estimating synergies is generally complex and judgmental, additional risk premiums will need to be considered in the estimation of the discount rate used in the |

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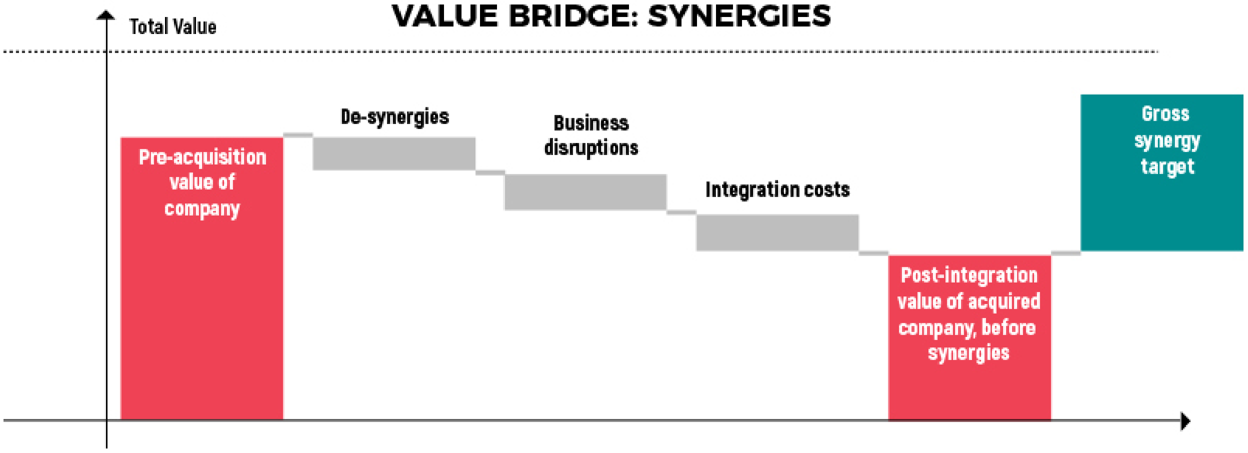
| cannibalisation of revenue. | net present value approach. |

The chart below illustrates the total business value in the instance where all the synergies quantified can be realised to their full potential. The value bridge is broadly illustrated as follows:




In the process of evaluating the synergies, the key drivers will be identified and the impact of synergies will be estimated, allowing acquirers to monitor the performance of the key drivers and hold relevant stakeholders accountable after the M&A. This will increase the chances of the identified synergies being realised to their full potential.

## Moving forward

In a rapidly evolving market landscape, we anticipate that the valuation of corporate synergies is going to be a key component in driving M&A deals, particularly in pricing considerations. It is integral for all interested parties to understand the implication of synergies and set realistic expectations on how much additional value the synergies can bring to the deal. With comprehensive evaluation and timely executions, synergies can be value-adding to the entities involved, and vice versa. One plus one is only greater than two, when the gross synergy target is more than the de-synergies and the costs of business disruptions and business integration.

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*[1] 2016 Innovative Space of Scientific Research Journals "Mergers And Acquisitions Failure Rates And Perspectives*
*On Why They Fail"*
*[2] Harvard Business Review June 2016, Roger L. Martin "M&A: The One Thing You Need to Get Right"*
*[3] EY: Does your acquisition strategy nurture growth – or stifle it? EY Global, 2018*
*[4] EY: Nine steps to setting up an M&A integration program, Lucas Hoebarth and Elizabeth Kaske, 2021*

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***Note:*** *The views reflected in this article are the views of the authors and do not necessarily reflect the views of the global EY organisation or its member firms.*

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