Forensic Financial Accounting Analysis:
Examples from the palm oil industry relating to natural capital

London Sumatra: IFRS 7, 9, and 16; PSAK 30, PSAK 60, PSAK 71, and PSAK 73

A PwC report comparing Indonesia's Financial Accounting Standards Board (DSAK) and its PSAK standards with IFRS standards found mostly consistency between the two sets of standards. But there continue to be notable differences which have material effects on comparability.

London Sumatra, an Indonesian palm oil company, prepares its financial statements in accordance with the Indonesian Financial Reporting Standards (PSAK). These standards use historical cost accounting, rather than fair value accounting. Indonesia's partial adoption of IFRS and London Sumatra's use of PSAK not only affect comparability with peer companies, but also means that their financial reporting makes comparisons more difficult, or even risky. For this example, we assume that the standards employed to produce London Sumatra's financial statements were consistent with IFRS, unless otherwise specified.

<u>IFRS 9 and PSAK 71</u>

IFRS 9 is an accounting standard for financial instruments. It includes guidance for accounting for their recognition, measurement, impairment, and derecognition. It also covers hedging assets which are important in agricultural production.

IFRS 9 improves disclosure, requires earlier recognition of impairment losses on receivables and loans, and trade receivables, and requires that more assets be measured at fair value. Changes in fair value are recognized in profit and loss as when occurring. IFRS 9 seeks to improve the reporting accuracy of a company's current condition.

Between 2013 and 2017, London Sumatra's "other receivables – related parties" rose from Rp 5,772 million[i] to Rp 103,930 million[ii]. However, these balances include loans made to related parties. The company discloses that this increase is partly attributable to additional loans issued and accrued interests.

As an example, a loan was extended to PT Sumalindo Alam Lestari (SAL)[iii], a related party, to assist with funding their operational needs. London Sumatra disclosed that among the features of this loan is the ability of either party to terminate it at will, and to automatically extend it as often as needed.

Likely the company employed Indonesia's IFRS 9 equivalent – PSAK 71 – for classifying this loan. Yet, there are no specific disclosures on cash flows from prior interest payments and principal amounts received.

These missing important disclosures make it nearly impossible to objectively determine whether the economic substance of these transactions constitute a loan or equity investment. In turn, this means the firm's balance sheets are likely not representative of its true financial condition, especially with regard to liabilities. Investors relying on these amounts would be likely to underestimate their levels of debt and overestimate their creditworthiness.

IFRS 7 and PSAK 60

PwC's comparability report also found that PSAK 60[iv], an additional financial instruments standard having to do with disclosure is equivalent to IFRS 7. The standard requires that companies provide quantitative and qualitative details about the nature and extent of exposure to risks arising from financial instruments. More specifically, under IFRS 7.33 and 7.34[v], management should disclose, among other things:

- Valuation inputs, including discount rates, forecasted period and cash flows
- Risks involved (credit, liquidity & market risks)
- And disclosures about management's objective policies and processes for managing those risks

These disclosures allow investors and other stakeholders to evaluate the quality of the underlying assumptions for estimating the fair value of a firm's financial instruments.

In 2016, London Sumatra reported a Rp 60,027 million ($5 million) debt stake[vi] in a US non-public company, Heliae Technology Holdings. In 2017, the company reduced its investment in Heliae to Rp 19,439 million[vii]. When reducing the value of the notes London Sumatra did not provide an explanation for the change in reported value.

Further, they did not provide details on their Level 3 inputs which are needed to check the restatement of value of its investment in Heliae as required under IFRS 9's Fair Value Through Profit & Loss method (FVTPL) method. This omission is a potential violation of IFRS 7 and PSAK 60.

Without the required disclosures mandated by IFRS 7 and PSAK 60 it is not possible to verify the appropriateness of the reduction in value of Heliae Technology Holdings. It could be that the values reported should have been higher, or lower. Financial statement effects would include: the balance sheet, including assets reported; as well as the income statement, most likely in other comprehensive income.

IAS 17 and PSAK 30

IAS 17 and its PSAK 30 equivalent relate to the reporting of leases. London Sumatra reported Plasma Scheme Receivables of Rp 68,935 million[viii] and Rp 66,620 million[ix] in 2017 and 2016, respectively. These amounts are the sum of the development costs extended to farmers under the plasma scheme over the years.

According to IAS 17 (PSAK 30), the capitalization of these costs (in part or full) appears to be inappropriate because they do not mee the conditions necessary for capitalization. Instead, they appear to be operating leases. This is because, while the farmers are legally required to ultimately reimburse the financial institutions by selling their harvests to the intis, London Sumatra remains the ultimate owner and beneficiary of their labor and their land. As such, we can conclude that these costs represent a lease, which gave London Sumatra legal right to the crops, the land, and to manage production both directly and indirectly.

The plasma scheme does not seem to include the conditions that must be present for a capital lease under IAS 17 (now IFRS 16). Consequently, the development costs reported under plasma receivables most likely fall under operating lease and should have been expensed as incurred. Consequently, profitability of London Sumatra was likely overreported. Furthermore, common financial ratios that measure performance, such as return on equity would have been overstated, too.

IAS 39 and SFRS 39

SFRS 39 (equivalent in all ways to IAS 39) also relates to financial instruments and their recognition and measurement. With regard to a financial guarantee contract it states:

> "[A] contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument."[x]

The standard further requires that an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

These loans which were intended to fund the operations of plasma farmers actually benefit intis, like London Sumatra. This is because the company maintains legal title to harvests with plasma farmers legally required to pass all the harvests to London Sumatra, and at below market costs.

Yet, our analyses did not find evidence that the loan principal amounts of Rp 71,199 million[xi] in 2017, and Rp 65,371[xii] in 2016, issued under the plasma scheme, and collectively guaranteed by the group were recognized as liabilities to London Sumatra. Instead, the group treated these amounts as off-balance sheet and only requiring disclosures. By contrast, the inventories and biological assets which these loans help funded were recognized.

Granted, financial reporting grants discretion to companies and their executives. However, it seems that the financial guarantees arising from the legal and contractual requirements of the Plasma Scheme represent a liability under SFRS 39 for the Intis. If so, London Sumatra's liabilities are underreported, and their balance sheet quality overstated.

References

[i] London Sumatra. *Annual Report 2013.* P. 1.
[ii] London Sumatra. *Annual Report 2017.* P. 1.
[iii] London Sumatra. *Annual Report 2017.* P. 1.
[iv] PwC Indonesia. *PSAK Pocket Guide 2018.*
[v] IFRS Foundation. *IFRS 7 — Financial Instruments: Disclosures.*
[vi] London Sumatra. *Annual Report 2016.* P. 65. "The fair value of this financial asset as of December 31, 2016, is Rp 60,027 (million) which is Level 3 fair value based on unobservable market data."
[vii] London Sumatra. *Annual Report 2016.* P. 92.
[viii] London Sumatra. *Annual Report 2017.* P. 1.
[ix] London Sumatra. *Annual Report 2016.* P. 1.
[x] IFRS Community (27 May 2020). *Measurement of Financial Instruments (IFRS 9).*
[xi] London Sumatra. *Annual Report 2017.* P. 54.
[xii] London Sumatra. *Annual Report 2017.* P. 54.