Indofood Agri Resources: Financial Accounting

August 3, 2024, Plantation Owned by Indofood Agri Resources.

IFRS 16/SFRS 16

Singapore's Accounting Standards Council (ASC) has in recent years aligned itself in synch with all IAS/IFRS standards. Some firms continue to report under the previous standards, however. SFRS 16 paragraph B9 defines a lease as any contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

Indofood participates in Indonesia's Plasma Scheme and has many relationships with Smallholder farmers. Under both the terms of Indonesia's PIR Trans and the KKPA (e.g., credit granting) arrangements:

- The Inti (Indofood) is committed and contractually required to buy all inventories produced by its plasma scheme farmers
- Farmers are required to sell all their production to the Inti by law, and by extension
- The Inti controls or advise on the process – from seedlings to inventories.

Indofood reported Plasma Receivables of Rp 1,209 billion, which represents the sum of the development costs extended to farmers over the years. Based on SFRS 16, the capitalization of these costs (in part of full) appears to be inappropriate and may have resulted in overstatement of assets and income over the years such expenditures incurred.

SFRS 16 Paragraph B9 of the standard further outlines 5 requirements that must be present before a lease can be classified as a finance/capital lease. The plasma scheme does not seem to include any of these requirements.

A PWC report issued in 2009 also supports this analysis. It concludes that the plasma scheme does indeed contain a lease arrangement for accounting purposes. Consequently, the development costs reported under plasma receivables most likely fall under the criteria for operating leases and should have been expensed by Indofood in the period incurred.

IAS 39/SFRS 39 SFRS 39

establishes standards for loan guarantee reporting. Indofood's 2017 and 2016 disclosure appropriately noted the circumstances under which recognition would be required. However, our investigation did not come across evidence that the Plasma Scheme loan principal amounts collectively guaranteed by the group of Rp 805 billion in 2017 and Rp 719 billion in 2016 were recognized as liabilities. Instead, the group seems to have treated these amounts as off-balance sheet items requiring more disclosures.

AS 41/SFRS 41

Indofood's accounting disclosures acknowledge that the group employs SFRS 41 as the basis for reporting agricultural and biological assets. Identical to IAS 41, the standard describes the conditions required for assets to be classified as biological assets or agricultural produce. The standard also specifies how these assets should be valued.

Specifically, IAS 41 requires companies to assess the fair value of their natural capital over time, including revaluing for gains and losses.

Accounting Standard Codification Section 905 Agriculture. In the US, however, Accounting Standard Codification (ASC) 905 takes the conservative approach by mandating the lower of costs or market approach. Although ASC 905 is beyond the scope of this analysis, it's worth noting that it closely aligns with paragraph 30 of IAS 41, which requires historical cost recognition less depreciation and impairments. Furthermore, paragraph 30 explicitly notes that "there's a presumption that fair value can be measured reliably."

IAS 41's guiding principle is that the increase in value associated with capital assets should be recognized as the asset grows, and not solely at the date of harvest or sale. In determining value of the future agriculture crops, agriculture companies can outsource this estimation of the value to external experts who apply a three-level approach to estimating the fair value of these agriculture assets:

- **Level 1 assets**: Assets whose value is measured according to readily observable market prices. These assets require a liquid market with multiple and consistent pricing sources, such as stocks, bonds, or any assets, which have a regular "mark-to-market"1 mechanism for setting a fair market value. Level 1 assets "mark-to-market" values must be easily observable, have transparent prices and therefore are a reliable, fair market value.

  Mark-to-market" or fair value accounting occurs when an asset or liability is valued at "fair value", which refers to the current market price in a liquid market, current market price in an illiquid market based on similar assets and liabilities, or based on another assessed "fair" value, in this case often determined by a consultant.

- **Level 2 assets**: Assets who lack a liquid market with multiple and consistent pricing but can be given a fair value based on quoted prices in inactive markets, such as interest rate swaps or securities that are not actively traded including loans, municipal bonds, currency swaps, loans and derivatives.
- **Level 3 assets**: Assets that are not actively traded and are the least "mark-to-market" of the three levels, where assets are priced based on expert opinion, estimates, mathematical models and unobservable inputs. Level 3 uses a process called "mark-to-management" to value assets. Examples of level 3 assets include complex derivatives, mortgage-backed securities, distressed debt, land, private equity shares and many assets valued under IAS 41.

Companies that employ a Level 3 approach to agriculture asset valuation typically value their natural capital using discounted cash flow (DCF) models. DCF modelling estimates the fair value of natural capital by reference to the expected future cash flows generated from the use of this capital.

Applying DCF modelling lets companies account for direct costs, such as maintenance, harvesting, overhead and transportation. However, these additional considerations can introduce uncertainty into concluded valuation if they are based on unreliable assumptions. The risk can be greater for agricultural firms who also need to incorporate assumptions relating to the impact of weather and environmental changes, such as global warming, into their forecasts.

SFRS 41 states that the biological assets shall be measured initially and at the end of each reporting period if 3 distinct conditions are present:

- the entity controls the asset as a result of past events
- it is probable that future economic benefits associated with the asset will flow to the entity
- the fair value or cost of the asset can be measured reliably.

SFRS 41 identifies level 1 inputs (quoted market prices) as the most reliable set of data for that purpose. By contrast, Indofood in its valuation of biological assets uses level 3 inputs. These require highly subjective economic and market assumptions about outcomes many decades into the future.

With regard to IFRS 16/SFRS 16: Leases, it is our belief that Indofood's capitalization of development costs spent on plasma farmers were likely inappropriate and may have resulted in overstatement of assets and income over the years such expenditures incurred. Consequently, investors would have misunderstood the financial position, operating profitability, and overvalued Indofood.

A lack of evidence of Indofoods' loan principal guarantees to plasma farmers of Rp 805 billion in 2017 and Rp 719 billion in 2016, as required by IAS 39/SFRS 39, probably means the firm classified this as off-balance sheet. Consequently, liabilities were likely underreported. This, in turn, would have led to an overestimate of its financial position as measured by ratios such as debt to equity, or total debt to total capital, among others.

Finally, with regard to IAS 41/SFRS 41, our assessment concluded that Indofood's choice of Level 3 reporting likely relies on flawed assumptions in its valuation models. These include unexpected crude palm oil (CPO) price movements; a frequent need to restate financial information after issuance; and the need to book impairment losses after increasing asset value. We do not believe management's use of fair market value is appropriate under the circumstances.