Draft for comments

MALAYSIAN INSTITUTE OF ACCOUNTANTS

CHARTERED TAX INSTITUTE OF MALAYSIA

The Malaysian Institute of Certified Public Accountants

TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 102: INVENTORIES

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1 INTRODUCTION

1.1 BACKGROUND OF THE FRS 102

1.1.1 Rationale

To reduce or eliminate alternatives, redundancies and conflicts within the standards, to deal with some convergence issues and to make other improvements.

1.1.2 Scope

Applies to all types of inventories, except for:

(a) WIP arising under construction contracts, which is governed under FRS 111.
(b) Financial instruments.
(c) Producers' inventories of livestock, agricultural and forest products and mineral ores.

Commodity broker-traders who measure their inventories at fair value less costs to sell are excluded from the measurement requirement of this standard.

1.1.3 Definition of essential terms

(a) Introduced the new concept of "fair value" which is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

(b) Elaborated on the meaning of "net realisable value" and "fair value".

1.1.4 Effective Date

Annual reports beginning on or after 1 January 2006. Earlier application is encouraged.

2. SCOPE OF THE COMMENTS

The comments below provide an analysis of the relevant FRS changes which would give rise to a tax impact.

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3. CHANGES INTRODUCED BY THE FRS REGIME

3.1 THE MASB REGIME

3.1.1 Inventories should be measured at the lower of cost and net realisable value.

3.1.2 Costs of inventories are assigned using the FIFO or weighted average method.

3.1.3 LIFO is allowed as an alternative method for assigning costs to inventories.

3.1.4 MASB 2 did not exclude the measurement requirement for inventories of a commodity broker-trader which are measured at fair value less costs to sell.

3.1.5 It has not specifically prescribed a measurement method for inventories which are purchased on credit terms.

Example:
Let us say, inventory is purchased on the credit terms: 2/10, net 60.

If the entity takes advantage of the credit terms and pays after 10 days, it must pay RM1,000 to the trade creditor. The double entries are:

	Debit (RM)	**Credit (RM)**
Inventory	1,000	
Trade creditor		1,000

	Debit (RM)	**Credit (RM)**
Trade creditor	1,000	
Bank		1,000

3.1.6 Matching principle applies in that the carrying amounts of the inventories that have been sold are recognised as an expense to match with the revenue generated from the sale.

3.1.7 Exempt enterprise need not comply with:

(a) disclosure of the amount of any reversal of any write-down that is recognised as income in the period.
(b) disclosure of the circumstances or events that led to the reversal of a write-down of inventories.
(c) disclosure of the cost of inventories and operating costs recognised as an expense during the period.

3.2 THE FRS REGIME

3.2.1 Items 3.1.1 and 3.1.2 as mentioned above regarding measurement of inventories and assignment of costs to inventories continue to apply here.

3.2.2 The following are not within the scope of FRS 102:

(a) a commodity broker-trader whose inventories are measured at fair value less cost to sell.
(b) exempt enterprise.

3.2.3 Applies to all inventories within the scope of FRS 102, whether or not they are held under the historical cost system.

3.2.4 When inventories are purchased with deferred settlement terms, the difference between the purchase price for normal credit terms and the amount paid is recognised as interest expense over the period of financing.

Example:
Let us say, inventory is purchased on the credit terms: 2/10, net 60.

If payment is made within 10 days, the entity is entitled to a 2% cash discount, and pays RM980 to the trade creditor. The double entries are:

	Debit (RM)	**Credit (RM)**
Inventory	980	
Trade creditor		980

	Debit (RM)	**Credit (RM)**
Trade creditor	980	
Bank		980

If the entity takes advantage of the credit terms and pays after 10 days, it must pay RM1,000 to the trade creditor. The difference of RM20 is recorded as an interest expense. The double entries are:

	Debit (RM)	**Credit (RM)**
Inventory	980	
Trade creditor		980

	Debit (RM)	**Credit (RM)**
Trade creditor	980	
Interest expense	20	
Bank		1,000

3.2.5 Prohibit the alternative treatment, i.e. the LIFO method for measuring inventories.

3.2.6 Eliminate reference to the matching principle of costs and revenues in respect of the carrying amount of inventories sold.

3.2.7 Cost of inventories of service providers shall not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

4. TAX TREATMENT BEFORE FRS IMPLEMENTATION

The tax treatment is provided under Section 35 of the Income Tax Act 1967. Section 35(2) provides that:-

(a) Where the value of Closing Stock exceeds that of Opening Stock, the excess would be deducted against the total tax deductible expenses; and

(b) Where the value of Opening Stock exceeds that of Closing Stock, the excess would be added to the total tax deductible expenses.

Section 35 (3) further provides that Stock in trade for immovable properties, stocks, shares or marketable securities is valued based on its cost or market value, whichever is the lower. For other types of stocks, they could be valued based on their market value or at cost, if election is made.

The effect of Section 35 is that all appropriate write down of inventories to its market value would be deductible for tax purposes. This treatment is affirmed by the Special Commissioners case of VKM Sdn Bhd vs Ketua Pengarah Hasil Dalam Negeri

Example 1

	RM	**RM**
Sales		1,000
Opening stock	100	
Purchases	500	
	600	
Closing stock	(120)	(480)
		520
Less: total deductible exp		(360)
Adjusted Income		160
		=====

In the above example, the closing stock exceeds the opening stock. As such, the excess of RM20 is deducted against the total expenditure and thereby reduce the cost of sale by RM20.

Example 2

	RM	RM
Sales		1,000
Opening stock	100	
Purchases	500	
	600	
Closing stock	(70)	(530)
		470
Less: total deductible exp		(360)
Adjusted Income		110
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In example 2, as the opening stock exceeds the closing stock, the excess of RM30 is added to the total expenditure and thereby increase the cost of sale by RM30.

5. SITUATIONS WHERE TAX ISSUES MAY ARISE AFTER FRS IMPLEMENTATION

5.1 INVENTORIES MEASURED AT NET REALISABLE VALUE(NRV) / FAIR VALUE

What is the appropriate tax adjustment to the measurement of closing stocks for stocks which are measured at the lower of cost or NRV.

5.2 INVENTORIES PURCHASED ON CREDIT TERMS

What is the appropriate tax adjustment to the imputed “interest cost” on inventories which have been purchased on credit terms from the trade creditors

6. TAX TREATMENT UNDER FRS BASED ON EXISTING LAW

6.1 INVENTORIES MEASURED AT NET REALIZABLE VALUE (NRV) / FAIR VALUE

Under FRS (also MASB), inventories are measured at the lower of cost and NRV.

“NRV” is defined as the estimated selling price less the estimated costs of completion and the estimated costs necessary to make the sale. “Fair value” is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.

Thus, the market value of an inventory is equal to its fair value and that NRV is not the market value of the inventory. .

Where the fair value is higher than cost, the cost would be regarded as the value of the stock for tax purpose under section 35 of the Act.

Where the fair value is lower than the cost, the fair value would be used for tax purposes.

Where the fair value of stock is lower than cost, tax adjustment would have to be made by reinstating the value of the inventory from NRV to its fair value and by adding back the "cost to sell" which has been deducted from the fair value of the inventories.

For example, if the fair value of an item is RM100 and the cost to sell is RM8, the value of stock stated in the account would be RM92. However, for tax purposes, the market value should be RM100. As such, RM8 would have to be added in the tax computation and appropriate adjustment has to be made in the value of the opening stock in the following year.

The above treatment would mean that an entity would have to maintain another set of records for its inventories for tax purposes.

6.2 INVENTORIES PURCHASED ON CREDIT TERMS

Pursuant to Section 35, the imputed interest should be treated as forming part of the cost of the inventory as has been the treatment prior to the introduction of FRS 102.

It thus means that the practical problems would be:

- The need to identify and add back such interest charged to the income statement; and
- The need to maintain a movement of the inventories based on the historical cost method.

7. INTERNATIONAL TAX PRACTICE

7.1 SINGAPORE

In Singapore, all write down of inventories to its net realisable values are tax deductible**.** There was no change of the legislation after the introduction of FRS 2.

No practical issues encountered because not many purchases made under deferred settlement terms.

7.2 AUSTRALIA

The tax legislation stipulates specific provisions for the valuation of trading stock. This is contained in Division 70 of the Income Tax Assessment Act 1997. It provides that an entity must elect to value each item of trading stock at:

- its cost; or
- its market selling value; or
- its replacement value.

The legislation does not make any reference to accounting principles when valuing trading stock at its cost. However given that the legislation does not provide any definitive guidelines as to the definition of cost, the Courts have applied commercial and accounting principles in a number of cases to determine the cost of trading stock.

Accordingly the ATO has stated that it will generally accept an entity's calculation of the cost of trading stock on hand for the purposes of Division 70 where the cost is determined in accordance with the costing principles as enunciated in AASB 102.

However the ATO has stated that whilst the use of costing for valuing trading stock in accordance with AASB 102 would often produce an acceptable value of the cost of trading stock for taxation purposes, this would not always be the case. Taxation Ruling TR 2006/8 states that differences may arise as taxation principles and accounting principles may be contradicting. Accordingly, the ATO has released some extensive detailed guidelines on how to value trading stock at cost. Whilst this ruling acknowledges the accounting principles it disregards those which are not in line with taxation principles.

Therefore for taxation purposes, accounting principles will be used to determine the value of trading stock at its cost as long as those principles are not contrary to taxation principles.

7.3 UNITED KINGDOM

The general tax treatment of inventories is that the profit or loss for tax purposes is based on inventories valued in accordance with accounting standards. This can be either UK GAAP or IAS, whichever is used by the company to draw up its financial statements. Carrying value for inventory is the lower of cost and net realisable value. Cost includes overheads.

Because UK tax follows accounts drawn up in accordance with GAAP, a change in accounting standard does not require a change in tax law. As regards inventory accounting standard, as the requirements of IAS2 accorded closely to the pre-existing requirements of SSAP9, no changes to UK GAAP were required to align UK GAAP with IAS2. Hence there was no change to tax.

As IAS2 did not require changes to the UK GAAP in SSAP9, IAS2 did not cause any practical difficulties.

8 PROPOSALS/RECOMMENDATIONS OF TAX TREATMENT

It is proposed that Section 35 be amended to accept the valuation of an entity which adopts FRS 102 to value its stock. In addition, the "imputed interest" for stock purchase under credit term should be treated as tax deductible interest expense.

We believe that the above proposal, if implemented, should not give rise to any loss of revenue to the Government in the long run as the tax effect relating to stock valuation is only timing difference since the closing stock of a year becomes the opening stock of the following year.

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However, it would eliminate the need for businesses to keep separate records for tax purposes and to make any tax adjustment on the value of stock which have been valued strictly in accordance with FRS 102. It would help to reduce compliance cost and hence the cost of doing business.