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 121: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

Prepared by:
Joint Tax Working Group on FRS

Tax Implications Related to the Implementation of FRS 121: The Effects of Changes in Foreign Exchange Rates

Contents

Tax Implications Related to the Implementation of FRS 121: The Effects of Changes in Foreign Exchange Rates

1. INTRODUCTION

1.1 BACKGROUND OF FRS 121

1.1.1 Rationale

FRS 121 was issued to stipulate the accounting principles underlying the recognition of foreign currency transactions and the translation of foreign currency financial statements into the local currency as presented in the financial statements.

1.1.2 Scope of FRS 121

FRS 121 shall be applied:

a. In accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of FRS 139;
b. In translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and
c. In translating an entity's results and financial position in a presentation currency.

1.1.3 Definition of essential terms

a. Closing rate is the spot exchange rate at the balance sheet date;
b. Foreign currency is a currency other than the functional currency of the entity;
c. Functional currency is the currency of the primary economic environment in which the entity operates;
d. Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency; and
e. Presentation currency is the currency in which the financial statements are presented.

1.1.4 Effective date

Annual periods beginning on or after 1 January 2006

2. SCOPE OF COMMENTS

This paper covers the effects of two stages translation of currency, as introduced by the FRS 121, where the presentation currency is not the functional currency.

Tax Implications Related to the Implementation of FRS 121: The Effects of Changes in Foreign Exchange Rates

3. CHANGES INTRODUCED BY THE FRS REGIME

3.1 THE MASB REGIME (MASB 6)

3.1.1 Foreign Currency Transactions

Foreign currency transactions are recorded, on initial recognition, at the spot rate. At each balance sheet date:

a. Foreign currency monetary items are reported at closing rate, unless there are related or matching forward contracts in respect of trading transactions, in which case, the contract rates are used;
b. Non-monetary items which are carried at historical cost are reported using the exchange rate at the date of the transaction; and
c. Non-monetary items which are carried at fair value are reported using the exchange rates at the date when the values were determined.

Exchange differences at this juncture are recognised in the income statement.

3.1.2 Financial Statements of Foreign Operations

If the foreign operations are integral to the operations of the reporting enterprise, the financial statements of the foreign operations are translated as in 3.1.1 above.

Otherwise, the reporting enterprise uses the following procedures:

a. The assets and liabilities, both monetary and non-monetary, of the foreign entity are translated at the closing rate;
b. Income and expense items of the foreign entity are translated at the exchange rates at the dates of the transaction; and
c. All resulting exchange differences are recognised in equity.

3.2 THE FRS REGIME (FRS 121)

3.2.1 Foreign Currency Transactions

Stage 1 – Translation to Functional Currency

Foreign currency transactions are recorded, on initial recognition, at the spot rate. At each balance sheet date, translation from foreign currency to functional currency is done as follows:

a. Foreign currency monetary items are reported at closing rate;
b. Non-monetary items which are carried at historical cost are reported using the exchange rate at the date of the transaction; and
c. Non-monetary items which are carried at fair value are reported using the exchange rates at the date when the values were determined.

Exchange differences at this juncture are recognised in the income statement.

Stage 2 – Translate to the Presentation Currency

The results and financial position of the entity are translated from the functional currency to the presentation currency as follows:

a. Assets and liabilities for each balance sheet presented are translated at the closing rate;

b. Income and expenses for each income statement are translated at exchange rates at the dates of the transactions; and

c. All resulting exchange differences are recognised as a separate component of equity.

4. TAX TREATMENT BEFORE FRS IMPLEMENTATION

There are no specific provisions in the Income Tax Act, 1967 on exchange profits and losses. Generally, for income tax purposes, profits or losses have not arisen until they are realised.

Foreign exchange gains or losses of a capital nature, whether realised or unrealised, are not taxable or allowable for income tax purposes. Whether a transaction is capital or revenue in nature depends on the facts and circumstances of each case.

Foreign exchange gains or losses of a revenue nature are taxable or allowable only when they are realised. Such gains or losses are realised when the foreign currencies are physically converted into or exchanged for currencies of the business. In this regard, businesses would need to trace each individual transaction to establish if physical conversion of foreign currencies has occurred.

The "Deemed Realised in the Following Year" basis in respect of revenue items has been allowed by the IRB.

5. TAX ISSUES ARISING FROM FRS 121 IMPLEMENTATION

In general, FRS 121 requires companies which have determined and adopted the functional currency (eg USD) to record all their transactions in that currency. Accordingly, all transactions which are not denominated in USD will need to be converted into USD using the rate specified by FRS 121. Thereafter, for presentation purposes, these USD amounts will be converted back to RM by using the closing rate for balance sheet items and at the exchange rates at the dates of transactions for profit and loss items.

5.1 CLAIM OF CAPITAL ALLOWANCES

FRS 121 requires the use of closing rate method. Under this method, assets and liabilities are to be translated using the closing rate. As such, all property, plant and equipment (PPE) acquired during a financial year are converted to RM based on the closing rate instead of the actual foreign exchange rate on the date of transaction or settlement date.

	Balance as at 01.01.2008 RM	**Additions RM**	***Exchange Difference for Additions***	**Balance as at 31.12.2008 RM**
Industrial building	40,000,000	1,000,000	*(95,000)*	40,905,000
Plant and machinery	25,000,000	800,000	*(65,000)*	25,735,000
Motor vehicles	5,000,000	80,000	-	5,080,000
	70,000,000	**1,880,000**	***(160,000)***	**71,720,000**

Issue: Should capital allowances be claimed based on the exchange rate on the actual transaction date or the closing rate used in the audited accounts?

Tax treatment: Capital allowances should be claimed on RM1,880,000 as in the existing legislation. If we were to follow the conversion which is based on the closing rate, the amount eligible will be reduced or increased by the exchange difference as the case may be (in this case reduced by RM160,000).

5.2 TRANSLATION OF FUNCTIONAL CURRENCY TO PRESENTATION CURRENCY

FRS 121 introduced the concept of functional currency and presentation currency. With this, the results and financial position of a company adopting USD as its functional currency if translated into presentation currency in RM may give rise to the following scenario:

Scenario
A Sdn Bhd has incurred an expense of RM3,500 when the exchange rate was USD1 : RM 3.50. The company has a sales transaction of RM7,000 on the same day.

Accounting Entry	DR	CR
On transaction date		
Expenses (P&L)	USD 1,000	
Creditor		USD 1,000
Trade debtors	USD 2,000	
Sales (P&L)		USD 2,000
Upon payment, the exchange rate is USD 1: RM3.40		
Creditor	USD 1,000	
Realised loss on foreign exchange(P&L)	USD 30	
Bank		USD 1,030
Bank	USD 2,059	
Trade debtors		USD 2,000
Realised gain on foreign exchange (P&L)		USD 59

Income Statement for the year ended			
	In functional currency (USD)	**Translated to presentation currency RM**	**Under normal RM account**
Sales	2,000	7,000	7,000
Add/(Less) : Expenses	(1,000)	(3,500)	(3,500)
Realised loss on forex	(30)	(102)	-
Realised gain on forex	59	200	-
Net profit	1,029	3,598	3,500

Issue: Should a tax adjustment be made on these foreign currency differences as the tax computation commence with the net profit in the presentation currency of RM3,598 to determine the chargeable income?

Tax treatment: Adjustment should be made on the differences based on the following:

Unrealised gain	Trade	Deduct
Unrealised loss	Trade	Add back
Unrealised gain	Non-trade	Deduct
Unrealised loss	Non-trade	Add back

5.3. VALUATION OF INVENTORIES

Based on the scenario below, there is the effect of exchange rate differences in the opening and closing balance of “inventories”. This arose due to the different exchange rate used for the conversion of say, USD functional currency to RM presentation currency in the balance sheet (which is translated at the closing rate prevailing at the balance sheet date) and the income statement (which is translated at average exchange rate for the year).

Notes to the Financial Statements	**2008**	**2007**
At Cost:		
Raw materials	3,100,000	4,000,000
Work in progress	11,000,000	18,000,000
Finished goods		2,000,000
	14,100,000	**24,000,000**

Detailed Income Statement for the Year Ended	2008	2007
Revenue	**200,000,000**	300,000,000
Less : Cost of sales		
Opening inventories	2,000,000	1,000,000
Effects of exchange rate difference on opening balance	**60,000**	
Opening inventories	(1,940,000)	(1,000,000)
Cost of goods manufactured	**(184,000,000)**	(185,000,00)
	185,940,000	186,000,000
Less: Closing inventories	-	(2,000,000)
Gross Profit	14,060,000	112,000,000

Issue: Is there a need to adjust for this difference in the tax computation?

Tax treatment: As the inventories are artificially reduced, the profit is increased. Therefore, there is a need to adjust for tax.

5.4 COMPARISON OF FRS CONVERSION AND ACTUAL RM FIGURE

There is a difference in the conversion rate used to convert the actual RM incurred (based on invoices) into the functional currency (based on the exchange rate on the transaction date) and the rate used to translate from functional currency to RM for presentation purposes in the audited accounts at the financial year end.

Advertisement Account			
	Actual RM	**Converted to USD at 3.65**	**Converted back to RM for presentation purposes at 3.58**
Recruitment advertisement	1,095,000	300,000	1,074,000
Complimentary advertisement	11,680	3,200	11,456
	1,106,680	**303,200**	**1,085,456**

Using actual RM figure for analysis

	Actual RM	**Amount added back (RM)**
Recruitment advertisement	1,095,000	
Complimentary advertisement	11,680	11,680
FRS conversion exchange rate difference	(21,224)	
Per audited accounts	**1,085,456**	**11,680**

Using RM analysis and allocate the FRS conversion exchange difference to the respective category

	RM	Allocated to each category	Amount (after adjustment)	Amount added back(RM)
Recruitment advertisement	1,095,000	(21,000)	1,074,000	
Complimentary advertisement	11,680	(224)	11,456	11,456
FRS conversion exchange rate difference	(21,224)	-		
	1,085,456	**21,224**	**1,085,456**	**11,456**

Using FRS conversion

	Actual RM	Amount added back
Recruitment advertisement	1,074,000	
Complimentary advertisement	11,456	11,456
	1,085,456	**11,456**

Issue: Should the amount to be disallowed in the tax computation be RM11,680 or RM11,456?.

For the amounts incurred in RM in Malaysia, the final converted amount as shown in the audited accounts may be different from the actual amount incurred as reflected in the invoices. Amounts do not reconcile to the source documents/invoices since the original RM amounts have been translated at the rate prevailing on transaction date to USD and then translated back to the presentation currency in RM in the audited accounts thus giving rise to lengthy and unnecessary explanations during field audits. If the strict legal position is adhered to, additional efforts would be involved to trace each transaction in order to establish physical conversion of the foreign currencies into the functional currencies of the business had taken place before the foreign exchange gains or losses could be recognised for income tax purposes.

Also, for companies eligible for double deduction for premium on marine cargo insurance for example, the issue is whether the double deduction claim should be based on the actual RM incurred as supported by invoices or the RM amount as reflected in the audited accounts as the FRS converted net profit before tax is used as the starting point to determine the chargeable income in the tax computation.

Tax treatment: To adopt that shown in the audited accounts.

5.5. COMPUTATION OF INTEREST RESTRICTION

Issue : Where the computation of interest restriction is prepared based on month end balances, what is the conversion rate to be adopted for the first 11 months (say from January to November)?

Tax treatment : Since the year end amount is based on the closing rate, all the months should use similar rate. However, for simplicity, propose to use the actual RM amounts.

6. INTERNATIONAL TAX PRACTICE

6.1 SINGAPORE

IRAS allows a concessionary tax treatment for foreign exchange gains or losses of all businesses to follow accounting treatment, that is foreign exchange gains or losses from revenue transactions are taxable or deductible on an accruals basis rather than on a realised basis.

IRAS further requires its companies which maintain their financial accounts and prepare their financial statements in non S$ to file their tax returns up to the chargeable income in non S$ functional currencies. Tax payable is then converted to S$ at average exchange rate.

The IRAS sets out specific treatment for the following:

i. Unabsorbed tax items, TWDV of existing assets brought forward;
Ii. Cost of assets granted capital allowances or industrial building allowances;
Iii. Treatment of loss for group relief purposes.

Reference can be made to the following ***IRAS Circulars***:-

a) Income Tax Treatment of Foreign Exchange Gains or Losses for Businesses
b) Filing of Income Tax Computations and Financial Statements in Functional Currencies other than Singapore Dollars

6.2 HONG KONG

In reporting the annual accounts, translation of foreign currency transactions are necessary. However, for tax purposes, a foreign company may maintain its home country currency except that its assessable profits for each year must be expressed in HK dollar terms. Taxability of exchange gains or losses are relied upon the various tax cases. Reference can be made to *Part B : Taxation of Foreign Exchange Differences of the* Departmental Interpretation and Practice Notes No 42.

7. PROPOSALS/ RECOMMENDATIONS OF TAX TREATMENT

Clear guidelines setting out the tax treatment to be adopted by taxpayers in filing the tax returns should be issued by the Authorities to address the tax issues arising from the adoption of FRS in the audited accounts.

Taxpayers may be allowed an irrevocable election to adopt one of the following manner to present the audited accounts for the purposes of preparing the tax computation:-

a. In presentation currency (ie in RM); or

b. In functional currency (where RM is not the company's functional currency) and then convert to RM to ascertain the tax payable; or

c. In RM as per the actual transactions (without applying the FRS 121)- this amy give rise to maintaining 2 sets of accounts.