Draft Discussion Paper for Comments

MALAYSIAN INSTITUTE OF ACCOUNTANTS

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TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 123: BORROWING COSTS

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1 INTRODUCTION

1.1 BACKGROUND OF THE FRS 123

1.1.1 Rationale

FRS 123 was issued in May 2009 to supersede the existing FRS 123_{2004} Borrowing Costs. FRS 123 specifies the accounting treatment for borrowing costs incurred during the acquisition, construction or production of a qualifying asset.

1.1.2 Scope

FRS 123 shall be applied in the accounting for borrowing costs in general, except for borrowing costs incurred relating to the acquisition, construction or production of a qualifying asset measured at fair value (e.g. biological assets) and inventories that are manufactured in large quantities on a repetitive basis.

1.1.3 Definition of essential terms

(a) Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. Borrowing costs may include interest on bank overdrafts and short-term and long-term borrowings, amortisation of discounts or premiums relating to borrowings, amortisation of ancillary costs incurred in connection with the arrangement of borrowings, finance charges in respect of finance leases, and exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

(b) A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances, any of the following may be qualifying assets: inventories, manufacturing plants, power generation facilities, intangible assets, investment properties. Financial assets and inventories that are manufactured over a short period of time are not qualifying assets. Assets that are ready for their intended use or sale when acquired are also not qualifying assets.

1.1.4 Effective Date

Annual periods beginning on or after 1 January 2010.

2. CHANGES INTRODUCED BY THE FRS REGIME

(a) The MASB regime requires the expensing of borrowing costs on an incurred basis as the benchmark treatment. The allowed alternative treatment permits the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

(b) The FRS regime requires the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. All other borrowing costs shall be recognised as an expense on an incurred basis.

3. TAX TREATMENT

The deduction of interest as an expense is governed by the provisions of Section 33(1)(a) of the Income Tax Act, 1967.

Section 33(1)(a) provides that interest expense on money borrowed would be allowed as a deduction under the following two (2) circumstances:-

a. the borrowing is employed in the production of gross income;
b. the borrowing is laid out on assets used or held in that period for the production of gross income.

The purpose of borrowing money is an important factor in determining the deductibility of interest. Thus, where a company is carrying on a continuing business, it can be said that the incurring of the interest is incidental to or connected with the operations or activities regularly carried on for the production of income.

Similarly, if the money is borrowed to acquire plant and machinery and the asset is employed in acquiring taxable income, the interest applicable would be deductible.

For example, a company which borrows money to finance the construction of a factory is entitled to claim the interest as an expense incurred in the production of assessable income as this is incidental and relevant to the production of that income.

The interest paid or payable for a particular year or period must be considered for a deduction in that year or period. The interest expense cannot be accumulated every year (ie by capitalising it) and then claiming it as a deduction in the year when income or profits are generated.Inventories should be measured at the lower of cost and net realisable value.

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4. TAX ISSUES

FRS 123 requires the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. For accounting purposes, where an entity obtains borrowings to finance the acquisition of an asset that takes a substantial period of time to be ready for intended use or sale, the borrowing costs will be eligible for capitalisation as part of the cost of a qualifying asset.

1. In a situation where a policy of capitalisation is adopted, for example, a company constructing a factory will capitalise the borrowing cost to the cost of the factory. For tax purposes, the general rule is that if money is borrowed for the purpose of revenue or capital assets of a business or for meeting disbursement in carrying on the business or for acquiring property from which income is derived, the interest on money borrowed ranks for deduction.

Currently, the Inland Revenue Board has treated interest on borrowings for capital expenditure as part of the costs of the asset.

From a tax perspective, therefore because the borrowing cost is capitalised to the cost of the factory, one will need to identify the components of the costs capitalised so that a deduction can be made in respect of the borrowing costs in the year the costs are incurred.

2. If a company obtains funds for the construction of a factory and pending commencement of the construction activity, it may temporarily invest the amount borrowed. In this regard, FRS 123 allows the amount of actual borrowing costs to be reduced by the income derived from the temporary investment. For tax purposes, a detailed analysis would be required of the components of the costs so capitalised, as the interest income should be brought to tax in the year of receipt.

5. PROPOSALS/RECOMMENDATIONS OF TAX TREATMENT

Generally, there is no adverse tax implication arising from the adoption of FRS 123. It is proposed that in respect of tax issue 2 above, the net borrowing cost be accepted as the borrowing cost incurred for tax purposes as it effectively reflects the actual cost of borrowing. This would also eliminate the additional administrative requirement of maintaining separate records of the borrowing cost and interest income to facilitate the necessary tax adjustments.