



MALAYSIAN INSTITUTE OF ACCOUNTANTS



CHARTERED TAX INSTITUTE OF MALAYSIA



The Malaysian Institute of  
Certified Public Accountants

# **DISCUSSION PAPER**

## **TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 121: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES**

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

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

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## 1. INTRODUCTION

### 1.1 BACKGROUND OF FRS 121

#### 1.1.1 Rationale

FRS 121 stipulates 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 a two stage translation of currency, as introduced by the FRS 121, where the presentation currency is not the functional currency.

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## 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.

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## **Stage 2 – Translation 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, exchange profits or losses are not considered to 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, if USD is used as the functional currency, 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 exchange rates at the dates of transactions for profit and loss statement items.

### **5.1 CLAIM OF CAPITAL ALLOWANCES**

FRS 121 requires the use of closing rate method for balance sheet items. 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.

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## Example

	Balance as at 01.01.2008	Additions	Exchange Difference for Additions	Balance as at 31.12.2008
	RM (i)	RM (ii)	RM (iii)	RM (iv)
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
	<b>70,000,000</b>	<b>1,880,000</b>	<b>(160,000)</b>	<b>71,720,000</b>

**Issue:** Should capital allowances be claimed on qualifying expenditure in respect of the additions which are based on the exchange rate on the actual transaction date [column (ii)] or on qualifying expenditure based on the closing rate [column (ii) less (iii)] used in the audited accounts?

**Suggested tax treatment:** Capital allowances should be claimed on RM1,880,000 as provided 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

### MASB 6

Under the previous MASB 6, companies are required to keep their accounting records in a reporting currency.

#### Scenario 1

A Berhad has a 31 December financial year end with the RM as its reporting currency. In 2009, A Berhad recognised a sale transaction of RM7,000 during the financial year. As at 31 December 2009, the customer has yet to remit payment. Subsequent to the year end, the customer makes full payment.

#### A Berhad

Sales invoiced in RM7,000

#### 2009:

#### At balance sheet date (RM)

DR Trade receivables	7,000	
CR Revenue		7,000

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## 2010:

### At balance sheet date (RM)

DR Bank	7,000	
CR Trade receivables		7,000

### With implementation of FRS 121

FRS 121 has 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 2

A Berhad has a 31 December financial year end with the USD as its functional currency and RM as its presentation currency. During the last month of 2009, A Berhad recognised a foreign currency sale transaction of RM7,000 during the financial year with a spot exchange rate of USD1.00:RM3.50. As at 31 December 2009, the customer has yet to remit payment and the closing exchange rate was USD1.00:RM3.40. Subsequent to the year end, the customer makes full payment and the spot exchange rate on the payment date is USD1.00:RM3.60.

### A Berhad

Sales invoiced in RM = RM7,000

	Exchange rate	Transaction currency	Functional currency
		RM	USD
Transaction date	3.5	7,000	2,000
Balance sheet date (2009)	3.4	7,000	2,059
Settlement date	3.6	7,000	1,944
Balance sheet date (2010)	3.8		

### STAGE 1 : Recording in functional currency

#### 2009:

At transaction date	(USD)	(USD)
DR Trade receivables	2,000	
CR Revenue		2,000

*Being sales transaction recorded in functional currency*

#### At balance sheet date

DR Trade receivables	59	
CR Unrealised forex gain (P&L)		59

*Being unrealised forex gain resulting in translation of monetary items using closing rate*

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### STAGE 2 - Translation to Presentation Currency

At balance sheet date 2009	(RM)	(RM)
DR Trade receivables	7,000	
DR Exchange reserve	200 <sup>(ii)</sup>	
CR Revenue		7,000
CR Unrealised forex gain (P&L)		200 <sup>(i)</sup>

*Being translation to presentation currency at balance sheet date*

### 2010:

At settlement date	(USD)	(USD)
DR Bank	1,944	
DR Realised forex loss	114	
CR Trade receivables		2,059

*Being settlement of trade receivables*

At balance sheet date 2010	(RM)	(RM)
DR Bank	7,389	
DR Realised forex loss (P&L)	412 <sup>(iii)</sup>	
CR Trade receivables		7,000
CR Exchange reserve		801

*Being translation to presentation currency at balance sheet date*

**Issue:** Should a tax adjustment be made on these foreign currency differences in determining the chargeable income?

#### **Current tax treatment:**

Note (i): The exchange gain in the P+L of RM200 is not taxable as it is an unrealised gain at the balance sheet date. Hence the amount must be deducted in the tax computation.

Note (ii): The exchange reserve of RM200 in the balance sheet is merely a translation loss at balance sheet date as a result of FRS requirements. No tax adjustment is required.

Note (iii): The exchange loss of RM412 is a realised loss, hence is an allowable loss (assuming it relates to trade).

In preparing the income tax computation, additional resources is required to obtain detailed breakdown and movement of all transactions with the view to ascertaining whether these are realised or unrealised and trade or non trade items.

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### 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 rates 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
	<b>14,100,000</b>	<b>24,000,000</b>

Detailed Income Statement	2008	2007
Revenue	<b>200,000,000</b>	300,000,000
Less : Cost of sales		
Opening inventories	2,000,000	1,000,000
<b>Effects of exchange rate difference in opening balance</b>	<b>60,000</b>	
Opening inventories	(1,940,000)	(1,000,000)
Cost of goods manufactured	<b>(184,000,000)</b>	(185,000,000)
	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 the exchange difference in the opening balance (i.e. RM60,000) in the tax computation?.

**Suggested tax treatment:** As the inventories are artificially reduced by RM60,000, the profit has been accordingly increased. Therefore, there is a need to adjust for tax.

### 5.4 DISALLOWABLE EXPENDITURE : AMOUNT TO BE ADDED BACK

When 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, there is an issue on disallowable expenditure and the amount to be added back.

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<b>Advertisement Account</b>			
	<b>Actual Expenditure</b>	<b>Translate to functional currency USD1:RM3.65</b>	<b>Translate from functional currency presentation currency USD1:RM3.58</b>
	<b>(RM)</b>	<b>(USD)</b>	<b>(RM)</b>
Recruitment advertisement	1,095,000	300,000	1,074,000
Complimentary advertisement	11,680	3,200	11,456
	<b>1,106,680</b>	<b>303,200</b>	<b>1,085,456</b>

The amount to be disallowed using actual RM figure for analysis is as follows:

	<b>Actual (RM)</b>	<b>Amount added back (RM)</b>
Recruitment advertisement	1,095,000	
Complimentary advertisement	11,680	11,680
Translate to presentation currency - exchange rate difference	(21,224)	
Per audited accounts	<b>1,085,456</b>	<b>11,680</b>

Using RM analysis and allocating the exchange difference to the respective sub category of expenditure, the amount to be added back is as follows:

		<b>Allocated to each category</b>	<b>After translation to presentation currency</b>	<b>Amount added back</b>
	<b>(RM)</b>	<b>(RM)</b>	<b>(RM)</b>	<b>(RM)</b>
Recruitment advertisement	1,095,000	(21,000)	1,074,000	
Complimentary advertisement	11,680	(224)	11,456	11,456
	<b>1,106,680</b>	<b>21,224</b>	<b>1,085,456</b>	<b>11,456</b>

**Issue:** The complimentary advertisement expenditure is not an allowable expenditure. Should the amount to be disallowed in the tax computation be RM11,680 or RM11,456?.

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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. The 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.

**Suggested tax treatment:** To adopt the amounts shown in the audited account, i.e. RM11,456.

## 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)?

**Suggested 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. 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 present the audited financial statements 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 may give rise to maintaining 2 sets of accounts.