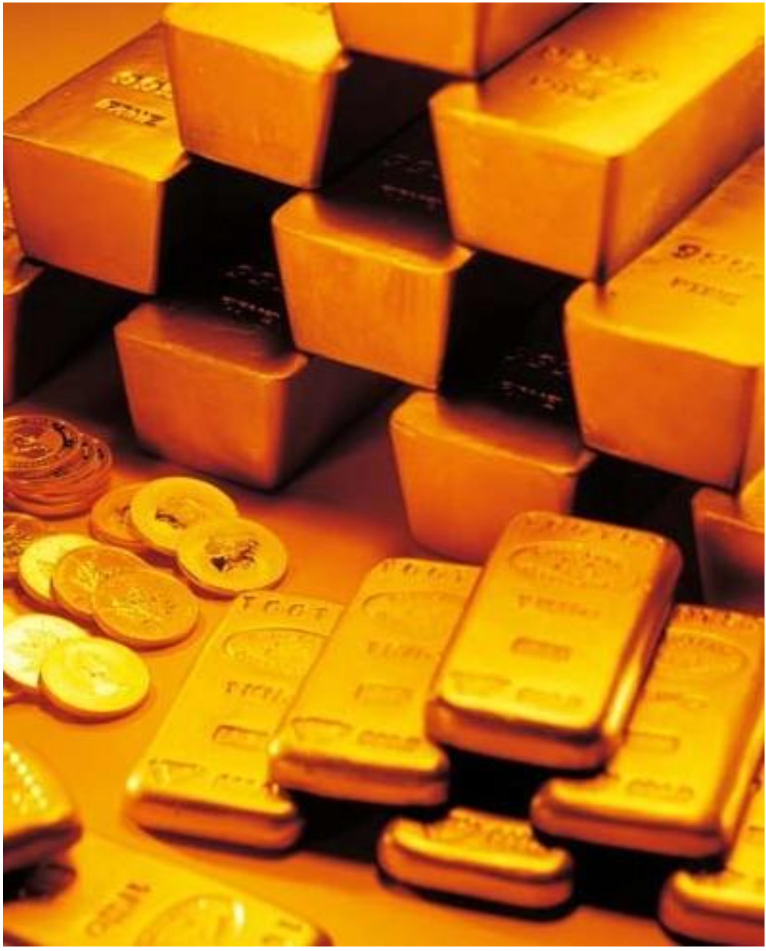
FRS 139, a Tax Dilemma

by **Kenny Lee**



Application of FRS 139 is already on shore for all companies in Malaysia under the FRS regime. The stan dard is one of the most challenging one and described by many as "the mother of all standards". Not only that FRS 139 is the most challenging one for Chief Financial Officers (CFO) but is equally a challenge for tax practitioners as well.

Familiarity with the essence of FRS 139 is paramount. Many CFOs by now would have realised the complexity of the standard when it comes to identifying Financial Instruments and treating them the way it should be as the lawmakers require. The standard to a great extent require CFOs to be have tip-top knowledge of all business transactions that entity is committed to. These transactions will need to be screened through to see if there are elements of Financial Instruments and Derivatives which will require fair valuation and on balance sheet treatment.

Fair value is the core in FRS 139. Entities are required to fair value the Financial Instruments which they have appropriately recognised. In the course of measuring these Financial Instruments, the concept of "marked to market" and "marked to model" using an effective interest rate are the most common approaches in 'fair valuing' the Financial Instruments. The effect of any fair value will at the end of day result in charge or credit to the Income Statement or Reserve Accounting through the Changes in Equity Statement as the case may be.

When you have charges or credit that flows through your Financial Statements, you will be faced with another challenge, Corporate Tax. You will need to consider if the credit is taxable or the charges arising from the application of FRS 139 is allowable for tax. For instance, if you have debt including intercompany debts of say RM100 which you expect to be repaid in 3 years' time, assuming interest rate at 10% per annum, you will need to fair value the RM100 at an interest rate of 10% per annum at the beginning of Year 1. On a compounding basis you will have an interest stream of RM25.00 (Year 1 RM7.50, Year 2 RM8.25 & Year 3 RM9.25). You then fair value the debt to RM75.00 at the beginning of Year 1. Subsequently, you will then flow in the interest stream annually at end of Year 1 RM7.50, Year 2 RM8.25 & Year 3 RM9.25.

At the beginning of Year 1, RM25.00 will be a charge to your Income Statement as an "impairment of the debt" at the end of the reporting period. Thus, subsequently at the end of Year 1 to Year 3, you impute and recognise interest income of RM7.50 in Year 1, RM8.25 in Year 2 and RM9.25 in Year 3.

Effectively, from the scenario above you will note that there is an impairment charge of RM25.00 when you apply FRS 139. Thereafter, at the end of Year 1 to Year 3 you will credit interest income to your Income Statement. In both cases, there is no new cash inflow or outflow involved. But you will have a tax exposure on your yearly interest income for the non current debt in Year 1 to Year 3. In addition, you will also have a tax challenge to claim for the impairment charge of RM25.00, as this is not a specific allowance and you have no legal action on the debtor in contrast to a specific allowance for doubtful debt. Thus, it would be a double effect on the tax impact to the company under such a situation.

In reality the implication of FRS 139 can be quite a significant one for some companies as the actual non-current debts can actually run into millions. The tax challenges does not only end here, as there are also charges and credit under a mark to market condition on the financial instruments and hedging gains or losses can be equally significant to some companies which could have a material tax consideration as well.

The beginning of FRS 139 era definitely will require a thought-through process for CFOs, Tax Practitioners and the Key Management of companies when managing their financial reporting.

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