

DRAMATIC CHANGES IN ACCOUNTING FOR INTERCOMPANY LOANS

Under FRS 102 complex accounting may be required for simple intercompany loans as **Oliver Holt** explains.

Under FRS 4 *Capital Instruments* accounting for an intercompany loan was fairly straightforward. The loan was booked on initial recognition at the amount of the net proceeds (fair value of consideration less issue costs), usually with mirror treatment in both sets of books. Thereafter, the finance costs of the debt were allocated to periods over the term of the debt at a constant rate on the carrying amount. In many cases as the loan was interest free there was no further accounting until the loan was repaid.

Depending on the terms and conditions of an intercompany loan the change in accounting under FRS 102 can be dramatic. This will come as no surprise to entities that have previously grappled with the transition to IFRS where initial accounting at fair value of the debt instrument as opposed to the consideration is well established under IAS 39.

Under section 11 of FRS 102 a reporting entity has a choice of recognition and measurement rules for its financial instruments being the relevant rules in either:

- Sections 11 and 12 of FRS 102; or
- IAS 39; or
- IFRS 9 and/or IAS 39 as amended following publication of IFRS 9.

This choice, once made, applies to all the entity's financial instruments and it is not possible to cherry pick among these rules for different financial instruments. In each case, the disclosure rules in sections 11 and 12 apply and if the entity is a financial institution as defined in FRS 102, section 34 disclosure rules also apply.

Table 1: Rules for Preference Shares and Other Debt Instruments

FRS 102 classification	Debt in the form of:		
	Preference shares		Other debt instrument
	<i>Holder's accounting treatment (FRS 102.11.14(d)(i))</i>	<i>Issuer's accounting treatment</i>	<i>Holder and issuer's accounting treatment</i>
Basic (section 11)	FVTPL	Amortised cost	Amortised cost
Non-basic (section 12)	FVTPL	FVTPL	FVTPL

For the purpose of this article we will assume the reporting entity has chosen FRS 102's section 11 and section 12 for its financial instrument recognition and measurement rules. While the measurement rules for amortised cost discussed in the article apply to loans generally that are basic and accounted for at amortised cost, this article will focus on intercompany loans.

As intercompany loans fall within the definition of a financial instrument the starting point is to determine whether the instrument is required to be classified as basic or non-basic. Section 11 of FRS 102 indicates that many intercompany arrangements will be basic but it should not be assumed that this will always be the case – for example a convertible debt instrument is classified as non-basic for the holder. Classification as basic or non-basic is based on a set of rules rather than on any overarching principle. Note also that FRED 54 (February 2014) proposes to broaden the range of instruments that will fall into the 'basic' category.

The classification matters. For debt instruments only those classified as basic can be accounted for at amortised cost under section 11. Note that debt instruments can be at FVTPL if designated as such on initial recognition. Non-basic debt instruments fall into section 12 of FRS 102

and are generally dealt with at fair value with changes in fair value reflected in profit or loss (FVTPL). Measuring at fair value is more onerous than measurement at amortised cost because it requires a valuation to be obtained at each reporting date and also introduces volatility into profit or loss.

It should be noted that there are different rules for preference shares and for other debt instruments as illustrated in *Table 1*.

Where basic preference shares are accounted for differently by the holder in the group from the issuer the consolidation adjustments necessary to eliminate the intercompany loan are more complex.

INTERCOMPANY LOANS AT AMORTISED COST

On initial recognition, as an intercompany loan is a financing transaction, FRS 102 section 11 requires that it is measured at the present value of future cash flows. The standard requires use of the market rate of interest for a similar debt instrument at the date of initial recognition when discounting the cash flows.

The glossary (Appendix 1 to FRS 102) defines 'present value' as 'a current estimate of the present discounted value of the future net cash flows in the normal course of business.'

In some cases this will be a significant change from FRS 4, which required initial recognition at the net proceeds at the date of issue of the instrument. In particular, any difference between the cash amount (which usually would have been the carrying value under FRS 4) and the initial carrying amount of the loan (the FRS 102 present value calculated amount) is accounted for as a capital contribution or distribution.

Under FRS 102, the initial accounting at present value (PV) for such loan balances will be as set out in Table 2, where assuming no transaction costs, par will equate to the nominal amount of the loan.

Although an intercompany debt transaction may lead to an amount being accounted for as a distribution, it is not necessarily a distribution for legal purposes.

Table 2: Initial Accounting at Present Value for Intercompany Loan Balances

Interest rate on loan at inception	Maturity		
	On demand	Fixed maturity	Fix maturity with on demand feature
Market rate	PV=Par	PV=Par	PV=Par
Below market (incl zero) rate	PV=Par	PV=calculation of present value at market rate to maturity	PV=Par
Above market rate	PV=calculation of present value at market rate, i.e. discount as a perpetuity	PV=calculation of present value at market rate to maturity	PV=calculation of present value at market rate to maturity

It is accepted practice for group companies to make interest free loans to each other and this has not generally been regarded to date under Irish law as giving rise to distributions

for legal purposes. In cases where there is any doubt, legal advice should be taken on the matter.

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The amount credited to/debited from equity of a subsidiary (as a capital contribution or distribution) is not subsequently remeasured. In the case of a parent company, a distribution received will go to its profit and loss account; in contrast, a contribution made would increase the value of the investment in subsidiary (subject to impairment).

For both counterparties, the difference between the initial carrying amount of the loan and the amount repayable is amortised over the life of the instrument using the effective interest rate method. Interest is accrued using the effective interest rate (which is not necessarily the contractual rate).

In contrast to a loan, financial assets and financial liabilities that have no stated interest rate (and do not constitute a financing transaction) and are classified as payable or receivable within one year are initially measured at an undiscounted amount in accordance with paragraph 11.14(a).

An example is given in the standard to show how the effective interest rate method works, and this is where there is most impact on the accounting for a loan.

Where there is no difference between the initial carrying amount of the loan and the amount repayable, the effective interest rate is equal to the contractual interest rate, which is zero.

There are no specific transitional provisions relating to the accounting for intercompany loans so the requirements of FRS 102 must be applied fully retrospectively when transitioning. This will mean that the carrying amount of inter-company loans may need to be adjusted on transition, depending on the terms of the loans. The impact will be largest where an inter-company loan has not been made on market terms and is not repayable on demand.

In each case where there is an intercompany loan outstanding as of the date of transition to FRS 102 the reporting entity will need to run FRS 102 compliant numbers from the inception of the loan to arrive at the required figures. Any difference between the balance at date of transition to FRS 102 and the previously reported amount will be dealt with as a transition adjustment. There is no relief from these calculations on transition in section 35 of FRS 102 which deals with first time adoption.

Figure 1: FRS 4 treatment of Example 1 interest free loan with fixed repayment date

FRS 4 accounting

Parent's books

	Dr	Cr
Dr Intercompany loan receivable	100,000	
Cr Bank		100,000

Being issue of loan to subsidiary

The receivable will be classified as due in more than one year until the end of year 4 when the amount will fall due within one year. As the loan is interest free there are no further entries until year 5:

Dr Bank	100,000	
Cr Intercompany loan receivable		100,000

Being repayment of loan made to subsidiary

Subsidiary's books

	Dr	Cr
Dr Bank	100,000	
Cr Intercompany loan payable		100,000

Being receipt of loan from parent in year 1

The payable will be classified as due in more than one year until the end of year 4 when the amount will fall due within one year and therefore will be classified into current liabilities. As the loan is interest free there are no further entries until year 5:

Dr Intercompany loan payable	100,000	
Cr Bank		100,000

Being repayment of loan from parent

Let's look at three inter-company loan examples:

- ① Interest free loan with fixed repayment date;
- ② Interest free loan that is repayable on demand;
- ③ Loan with an above market rate of interest with fixed repayment date.

For each scenario unless otherwise stated we assume the following details regarding the intercompany loan:

- Parent advances cash of €100,000 to subsidiary at the start of year 1.
- The market rate of interest is 5%.
- The loan is repayable at the end of year five.
- There are no transaction costs.

Table 3: Amortised cost calculation for Example 1

Year	Carrying amount at beginning of period	Effective interest rate: interest at 5%	Cash payments	Carrying amount at end of period
1	€78,350	€3,920		€82,270
2	€82,270	€4,110		€86,380
3	€86,380	€4,320		€90,700
4	€90,700	€4,540		€95,240
5	€95,240	€4,760	(€100,000)	nil

**EXAMPLE 1:
INTEREST FREE LOAN WITH
FIXED REPAYMENT DATE**

The treatment of an interest free loan with a fixed repayment date under FRS 4 accounting is illustrated in *Figure 1*.

FRS 102 accounting

Assuming both parent and subsidiary apply section 11 and 12 measurement and recognition principles, the accounting will follow these steps:

- Step 1:** classify the financial instrument
- Step 2:** calculate the amount to be booked at initial recognition
- Step 3:** determine if there is any distribution/ capital contribution
- Step 4:** calculate amortised cost using the effective interest rate method

Step 1 – classification

The parent and subsidiary will each examine the terms and conditions of the loan from their own perspective and determine whether the loan is to be classified as basic or non-basic. In this example the loan is a basic financial instrument for both parties.

Step 2 – initial recognition

The amount at initial recognition is the present value of the cash flows using a market rate of interest: in practice this may be difficult to determine – for example the parent may access funding at a cheaper rate than its subsidiary due to a more robust credit profile, superior collateral, long standing banking relationship and so forth. Nonetheless, the rate to be used is the market rate that would prevail had the transaction been carried out with market participants at arm’s length. For ease of calculation we are assuming a 5% rate in the market as given above. The present value of €100,000 in 5 years if the market rate of interest is 5% is €78,350. This can be worked out by using present value tables or by using the formula $1/(1+R)^n$ (where R is the interest rate and ‘n’ the number of years) or by using the present value function in Excel.

Step 3 – capital contribution

In step 2 we calculated the present value of the €100,000 interest free loan not repayable for 5 years at €78,350. The difference of €21,650 in economic substance reflects the interest income foregone by the parent. As

this is an opportunity cost rather than an actual cost it does not meet the definition of an item to be recognised in profit or loss and accordingly is treated as a capital contribution by the parent to the subsidiary.

Step 4 – amortised cost calculation

The amortised cost of the loan is set out in *Table 3* (opposite).

In the parent’s book in year 1 the making of the loan will be accounted for as illustrated in *Figure 2*.

Figure 2: Accounting for the making of the Example 1 loan under FRS 102

<i>Parent's books</i>		
	Dr	Cr
Dr Intercompany loan receivable	78,350	
Dr Cost of investment in subsidiary	21,650	
Cr Bank		100,000
Being issue of loan to subsidiary in year 1		
The receivable will be classified as due in more than one year until the end of year 4 when the amount will fall due within one year. Notwithstanding that the loan is interest free and in contrast to FRS 4 accounting, there are entries to be made each year:		
Years 1 to 5		
Dr Intercompany loan receivable		
Cr Finance income in p/l		
Being the effective interest rate income on loan to subsidiary as shown in the table above for each respective year		
On loan being repaid to parent:		
Dr Bank	100,000	
Cr Intercompany loan receivable		100,000
Being repayment of loan by subsidiary		
Note that the cost of the investment in subsidiary (which includes the capital contribution recognised by the parent on making the loan in year 1) will only reduce on either a sale or impairment of the investment in the subsidiary – the repayment of the loan does not impact the investment in subsidiary amount.		
<i>Subsidiary's books</i>		
	Dr	Cr
Dr Bank	100,000	
Cr Intercompany loan payable		78,350
Cr Capital contribution reserve		21,650
Being receipt of loan from parent in year 1		
The payable will be classified as due in more than one year until the end of year 4 when the amount will fall due within one year and therefore will be classified into current liabilities. Notwithstanding that the loan is interest free there are entries to be made each year:		
Year 1 to 5		
Dr Finance cost in p/l		
Cr Intercompany loan payable		
Being the effective interest rate cost on loan to subsidiary as shown in the table previously for each respective year		
On loan being repaid to parent:		
Dr Intercompany loan payable	100,000	
Cr Bank		100,000
Being repayment of loan from parent in year 1		

Note that the capital contribution remains in the subsidiary's equity until the directors resolve to make a transfer from this reserve. As the loan has been received in cash (and hence 'realised'), the directors could resolve to transfer the amount from capital contribution reserve to the profit and loss account reserve as they see fit: immediately, during or at the end of the loan or not at all. Another possibility is that as the finance charges are made to profit and loss a corresponding amount of the capital contribution could be transferred to the profit and loss account reserve.

EXAMPLE 2 - INTEREST FREE LOAN THAT IS REPAYABLE ON DEMAND

In this example, the facts are as previously stated, the only difference being that the parent can demand repayment at any time prior to the maturity in year 5. The four-step analysis outlined above is performed bearing in mind that the present value of a financial asset or financial liability payable on demand is discounted from the earliest date it can be demanded. Note that this applies in the circumstances where the lender has the right to demand repayment, not that the borrower simply has a free choice to repay early.

FRS 4 accounting

Parent's and subsidiary's books

No change over that shown in *Figure 1*, except that the classification in the parent is as an amount due within one year and in the subsidiary as a current liability.

FRS 102 accounting

The entries for both the parent and the subsidiary under FRS 102 are the same as the entries under FRS 4. The loan remains classified as current. In this example, the present value reflecting the 'demand' feature is the same as the cash amount borrowed.

Table 4: Calculating the amount to be booked at initial recognition in Example 3

Year	Cash flow	5% discount factor	Amount
1	6,000	0.9524	5,714
2	6,000	0.9070	5,442
3	6,000	0.8638	5,183
4	6,000	0.8227	4,936
5	6,000	0.7835	4,701
5	100,000	0.7835	78,353
Present value of future cash flows at market rate			€104,329

Table 5: Calculating amortised cost using the effective interest rate method in Example 3

Year	Carrying amount at beginning of period	Interest at 5% (reflected in profit or loss)	Cash	Carrying amount at the end of period
	€	€	€	€
1	104,329	5,216	6,000	103,545
2	103,545	5,177	6,000	102,723
3	102,723	5,136	6,000	101,859
4	101,859	5,093	6,000	100,952
5	100,952	5,048	106,000	0

As previously noted, where there is no difference between the initial carrying amount of the loan and the amount repayable, the effective interest rate is equal to the contractual interest rate, which is zero. Consequently there are no entries to be made in years 1 to 5 as regards any finance income or cost.

EXAMPLE 3 - LOAN WITH AN ABOVE MARKET RATE OF INTEREST WITH FIXED REPAYMENT DATE

In this example the facts are as the same as in the first example, the only difference being that the parent charges an above market rate of interest coupon of 6%.

FRS 4 accounting

Parent's and subsidiary's books

As per the previous example, but in addition, a €6,000 finance income/cost to profit and loss each year to represent the 6% interest.

FRS 102 accounting

Step 1: classify the financial instrument

The instrument is a basic financial instrument – the above market rate of interest is not a feature of a non-basic instrument.

Step 2: calculate the amount to be booked at initial recognition

The amount at initial recognition is the present value of the cash flows using a market rate of interest (in this case 5%) as opposed to the contracted 6% rate, given the stated maturity is five years (*Table 4*).

Step 3: determine if there is any distribution/capital contribution

The cash amount of the loan is €100,000 but the present value amount required by FRS 102 from the table above is greater at €104,329. Accordingly the parent will earn a greater than market return on making the loan: when a subsidiary gives its parent 'money for nothing' it is, at least in accounting terms, a distribution. So there is a distribution to be accounted for of €4,329.

Step 4: calculate amortised cost using the effective interest rate method illustrated in Table 5

Table 5 illustrates for both the parent and subsidiary that under FRS 102 there is likely to be a different finance income or finance cost than the cash amount over the duration of a fixed interest loan.

In the parent's book in year 1 the making of the loan will be accounted for as set out in *Figure 3*.

TAXATION

The taxation of intercompany loans under FRS 102 has not been the subject of any pronouncements from the Revenue Commissioners, at least to date.

In *Example 1*, where a parent company grants a loan at below market rates to its subsidiary, on initial recognition an amount will be treated as a capital contribution. It is unlikely that a deduction would be allowed for this amount under Capital Gains Tax rules in the parent or be taxable in the subsidiary.

In most cases interest is taxed when it is received (or tax deductible when "laid out or expended") and not when it is accrued in the accounts. The interest income credited to the parent's P/L account as detailed in *Example 1* is unlikely taxable in the parent

Figure 3: Loan with an above market rate of interest with fixed repayment date from Example 3

<i>Parent's books</i>	Dr	Cr
Dr Intercompany loan receivable	104,329	
Cr Bank		100,000
Cr Profit or loss: distribution from subsidiary		4,329
Being issue of loan to subsidiary in year 1		
Notwithstanding that the contracted interest rates is 6%, the parent will recognise its finance income (interest column in Table 5) over the 5 years based on the amortised cost which reflects the market rate of 5%.		
<i>Subsidiary's books</i>	Dr	Cr
Dr Bank	100,000	
Dr P/I reserve: distribution to parent	4,329	
Cr Intercompany loan payable		104,329
Being receipt of loan from parent in year 1 with related distribution.		
Notwithstanding that the contracted interest rate is 6%, the subsidiary will recognise its finance cost (interest column in Table 5 above) over the 5 years based on the amortised cost which reflects the market rate at the inception of the loan of 5%.		

or to be an allowable deduction for the subsidiary as it is in the nature of a notional expense.

Example 2 (i.e. in instances where the parent can demand repayment of the loan at any time prior to the maturity in year 5) should not give rise to any unusual complexities from an Irish income tax or corporation tax perspective for either the parent or subsidiary as no entries are required to be made in years 1 to 5 as regards any deemed finance income or cost.

In *Example 3* the difference between the annual arm's length interest rate of 5% and the contractual interest rate of 6% should be treated as a distribution for tax purposes.

Accordingly, only the amount up to 5% is taxable/tax deduction. The remainder is dealt with each year as franked investment income (distribution). It is doubtful, however, whether the initial accounting recognition of a distribution of €4,329 would constitute a 'dividend' or 'distribution' for Irish tax purposes.

DEFERRED TAXATION

In the examples above where the recognition of interest in the accounts and in the tax computation are different there are timing differences and FRS 102 will require accounting for any material deferred tax consequences.

NEXT STEPS

Reporting entities with intercompany loans need to look at their financing arrangements and consider the issues they may encounter on the first time adoption of FRS 102, particularly as there is no grandfathering or other relief on transition.

For some (interest rate at inception at or below market) it may be a case of clarifying and documenting a pre-existing 'on demand' term. The simple insertion of a new clause prior to the date of transition to the effect that the holder (i.e. lender) has the ability to call the loan at any time may serve to simplify the accounting. Note that generally if there is a modification to the contractual terms of a loan after the date of transition, accounting adjustments may be required to account for the modification.

There may be unintended consequences, however, even with such a simple strategy. An 'on-demand' clause, for example, could be for nought in situations where to preserve the going concern status of the subsidiary the parent subsequently through a contractual modification undertakes not to call the loan.

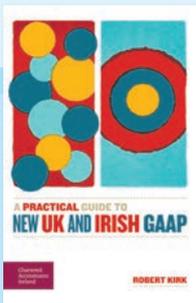
For dormant subsidiaries with interest free loans, section 35 on first time adoption may offer some relief (see FRS 102 section 35.10(m)) at least until there is a further transaction in the company.

The conclusion, however, is that inevitably there will be a considerable accounting effort required to successfully transition some intercompany loans into the new regime. ■

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