Grant Thornton

Technical Accounting Alert

Employee loans at low interest rates

Introduction

The purpose of this alert is to provide guidance for accounting for low interest rate loans to employees.

Relevant Australian standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 19 Employee Benefits	AASB 119 Employee Benefits
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement
IFRS 2 Share-based Payments	AASB 2 Share-based Payments
IFRS 9 Financial Instruments	AASB 9 Financial Instruments

Overview

Loans to employees are financial assets and should be recorded at fair value on initial recognition (IAS 39.43). Fair value can be estimated as the present value of the future cash flows, discounted at a market rate for a similar loan (IAS 39.AG64). The loan asset is subsequently accounted for in accordance with IAS 39. After initial recognition, loans are normally accounted for at amortised cost with interest income determined using the effective interest method.

If the interest rate on the loan is below the market interest rate, fair value will be less than the amount of the loan. This initial difference is an employee benefit. It should therefore be accounted for in accordance with IAS 19. In our view:

- If the benefit (ie the favourable terms of the loan) is **not dependent on future service** by the employee, it is a past service cost and should be recorded as an employee benefit expense when the loan is advanced (IAS 19.129).
- If benefit is **clearly linked to future employee service**, the initial difference should be recognised as an expense over the service period. This amount recorded as an expense can be estimated as the difference between:
  - the interest income for the period based on the fair value of the loan asset and the amortised cost using the effective interest method; and
  - the interest actually charged to the employee.

Detailed Analysis

Many entities make loans to their employees on favourable terms. The accounting standards do not include specific requirements on employee loans. The general requirements of the relevant standards are therefore applied.

Employee loans are financial instruments and are therefore within the scope of IAS 39 and IFRS 9. IAS 39.43 and IFRS 9.5.1.1 require that financial instruments are initially recognised at fair value. For loans made on market terms, fair value at inception will usually equal the loan amount. Where the loan is on favourable terms, the fair value of the entity's loan asset will be less than the loan amount.

Employee loans are usually included in IAS 39's loans and receivables category, IFRS 9's amortised cost measurement category. Accordingly, after initial recognition they are recorded at amortised cost using the effective interest rate (EIR). The loan asset is also subject to IAS 39's impairment requirements.
The difference between the loan amount and its fair value is, in substance, an employee benefit. The principles of IAS 19 therefore apply. However, IAS 19 does not provide any direct guidance on accounting for this form of benefit. In the absence of specific guidance, the general principles of IAS 19 should be applied to determine:

- whether the benefit should be recognised immediately or amortised over a longer period; and
- if amortised, the basis of allocating the expense into reporting periods.

Immediate expense recognition or allocation?

If the loan is available on favourable terms, irrespective of any future employment requirement or other service obligation, there is no basis on which to allocate any of the interest benefit to future periods. In IAS 19 terminology, the benefit is a past service cost. IAS 19 requires that past service costs relating to long-term benefits are expensed immediately (IAS 19.129(e)).

Sometimes the terms of a loan establish a clear link between the benefit and future service. Examples of this include employee loans that:

- are repayable if the employee leaves; or
- revert to a market interest rate if the employee leaves.

In these examples, although the employee receives the loan proceeds up front, the interest benefit is available only while the employee provides service to the entity. In accordance with the objective of IAS 19, an expense should be recognised when the employee provides services.

Basis of allocation

The allocation of the employee benefit expense depends (amongst other things) on whether the benefit is considered long-term or short-term in accordance with IAS 19. A benefit is long-term if some or all of it falls due more than 12 months after the employee provides service (IAS 19.7). This definition is difficult to interpret for a benefit provided in the form of a long-term loan. In our view, most low interest loan arrangements involve the payment of benefits in each period in which service is rendered and are therefore short-term. Other subsidised goods and services are also typically considered to be short-term benefits (IAS 19.8(d)). However, some arrangements might have conditions or features that make them long-term in nature.

Under short-term benefit accounting, the entity should recognise (in each period) the undiscounted expense payable in exchange for employee services in the period (IAS 19.10). The cost to the entity in each period can be estimated as the difference between:

- the interest income for the period based on the fair value of the loan asset and IAS 39's amortised cost using the effective interest rate method; and
- the interest payable by the employee.

Other methods of allocation might also be acceptable. A straight-line amortisation of the initial difference over the applicable service period is often a reasonable approximation of the amount attributable to each period (at least for loans with a fixed principal amount).

Short-term advances

Some entities might advance small amounts to employees on a short-term basis. The benefit component of such loans might be immaterial. In our view it is acceptable to record such advances at face value if there is no stated interest rate and the effect of discounting is immaterial, by analogy to the guidance on short-term receivables and payables (IAS 39.AG79).

Loans linked to the entity's shares

Loans linked to the entity's shares in some way need careful analysis. This type of arrangement may (wholly or partly) be within the scope of IFRS 2. For example, a loan made to an employee to purchase shares of the entity which is secured only over those shares, may in substance represent the grant of a share option. In an option-type arrangement, the loan proceeds are returned to the company in exchange for the shares at the inception of the scheme. The employee receives shares but is obliged either to make the loan repayments or to return the shares. At the maturity of the loan, the employee can choose to:

- surrender the shares, which is equivalent to allowing the notional share option to lapse; or
- repay the loan, which is equivalent to paying the exercise price of the notional share option.

This arrangement gives rise to a share-based payment expense determined in accordance with IFRS 2. The expense is recorded based on grant date fair value of the overall scheme. If the shares are surrendered, there are no further accounting entries. If the loan repayments are made, the company records an equivalent credit in equity in the same way as it would on receipt of the proceeds of exercise of a normal employee share option.

Employees are also sometimes issued with shares and provided with a "full recourse" loan to fund the share purchase. The full recourse loan is secured not only over the shares but also over other assets. A proportion of the loan may be forgiven if specified performance targets are reached (eg a specified increase in share price or earnings per share over a defined period). In such cases, it is necessary to assess the overall substance of the arrangement. For example:

- if in practice the loan is forgiven even if the targets are **not** achieved, or when an employee leaves, the substance of the arrangement may be an award of shares (rather than share options) to be accounted for under IFRS 2;
- if in practice the employees are allowed to "settle" the loan by giving back the shares if the targets are not achieved, the arrangement operates in a similar way to a loan with recourse only over the shares (see above);

- if the employees are required to settle the loan in cash if the targets are not achieved, or upon leaving, the arrangement may comprise both a contingently forgivable loan (see below) and an award of shares.

Finally, a loan that is not used to fund a share purchase, but is forgiven if the share price increases, satisfies the IFRS 2 definition of a cash-settled share-based payment.

Forgivable loans

An employee loan might be forgivable (for example, after a certain period of service or if performance targets are achieved). The terms and conditions of this type of arrangement should be evaluated to determine if it gives rise to any financial asset. The substance of such an arrangement might be that it is a prepaid employee benefit in its entirety. A loan that is forgiven after a certain period of service exceeding 12 months would be a long-term employee benefit.

Examples

Example 1

An entity makes a 5 year, interest free loan of $10,000 to an employee. The loan remains available whether or not the employee remains in service. The market rate for a similar loan is 10%.

Analysis

The loan is at a favourable rate of interest for the employee, and the $10,000 exceeds the fair value of the employer's financial asset. The fair value of the loan is estimated based on the future cash flow ($10,000 in five year's time) and the market interest rate (10%). This results in an initial carrying amount of $6,209. The loan is likely to be measured at amortised cost under IAS 39 / IFRS 9. In this case, the effective interest rate is 10%.

As the loan continues to be available if the employee leaves within the 5 year loan term, there is no clear link between the interest benefit and any future service. The interest benefit of $3,791 is therefore recognised as an expense at the date of the loan.

The journal entries on making the loan are as follows:

Initial recognition of loan with no future service component ($)	Debit	Credit
Cash		10,000
Loans and receivables	6,209	
Employee benefit expense	3,791	

Example 2

A bank makes mortgage loans to its customers at a market rate, which is currently 5%. It also provides loans to its employees of up to $500,000 at a discounted rate of 2%. The loans are for a 10 year period. The principal is repayable in equal annual instalments, along with interest due for the year. The loans remain available if an employee leaves, but the interest rate reverts to the current market rate. The entity estimates that employees on average remain in employment for 5 years from the date of advancing a loan.

The loans can be repaid early at their amortised cost. The early repayment option is considered to be a closely related embedded derivative in accordance with IAS 39.AG30(g) and is therefore not separated from the host debt contract.

Analysis

In this example, the terms of the arrangement provide a clear link between the interest benefit and future service. In determining the fair value of the loan, the expected cash flows will take into account any expected employee turnover. The expected cash flows for a loan of $500,000 are therefore:

- 10 repayments of principal at $50,000 per annum;
- 5 interest payments of the discounted rate of 2%; and
- 5 interest payments at the market rate of 5%.

These cash flows are discounted at 5% to estimate the loan's fair value. This is $447,413, which is $52,587 less than the loan amount. The loan is initially recognised at this fair value amount. Subsequently, interest income is recorded at the effective interest rate of 5%. The difference between the interest paid by the employee and the IAS 39 effective interest income is recognised in each of the first 5 years as an employee benefit expense. On initial recognition, the $52,587 interest benefit is recorded as a prepayment in accordance with IAS 19.10(a).

The relevant amounts and their calculation for a loan of $500,000 advanced on 1.1.X1 are shown in the following table:

Year	Cash flows			IAS 39 accounting		
	Principal	Interest at 2% then 5%	Total	Loan amount	Interest income at 5% EIR	Employee benefit expense
1.1.X1	(500,000)	-	(500,000)	447,413	-	-
20X1	50,000	10,000	60,000	409,784	22,371	12,371
20X2	50,000	9,000	59,000	371,273	20,489	11,489
20X3	50,000	8,000	58,000	331,837	18,564	10,564
20X4	50,000	7,000	57,000	291,429	16,592	9,592
20X5	50,000	6,000	56,000	250,000	14,571	8,571
20X6	50,000	12,500	62,500	200,000	12,500	-
20X7	50,000	10,000	60,000	150,000	10,000	-
20X8	50,000	7,500	57,500	100,000	7,500	-
20X9	50,000	5,000	55,000	50,000	5,000	-
20X10	50,000	2,500	52,500	-	2,500	-
NPV at 5%			**447,413**			-
Total						**52,587**

If expectations regarding an employee's future length of service change, this will affect the expected cash flows under the loan. The revised estimated cash flows are discounted at the original EIR (IAS 39.AG8). The remeasurement can be regarded as an adjustment to finance income or expense, or as an adjustment to employee benefit expenses.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au