Grant Thornton

Technical Accounting Alert

Inter-company loans

Introduction

This alert will give you an insight to the different treatments for intercompany loans, i.e. between parent and subsidiary or between subsidiaries.

Relevant standards

References 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 39 Financial instruments: Recognition and Measurement	AASB 139 Financial instruments: Recognition and Measurement
IAS 27 Consolidated and Separate Financial Statements	AASB 127 Consolidated and Separate Financial Statements
IAS 24 Related Party Disclosures	AASB 124 Related Party Disclosures

Summary

Loans are commonly made between entities in a group on a non-arm's length terms (ie terms that are favourable or unfavourable in comparison to the terms available with an unrelated third party lender). For example, inter-company loans are often:

- interest free or have a below-market rate of interest; and/or
- made with no stated date for repayment.

Loans are within the scope of IAS 39 and complications arise if they are not on arm's length terms. The fair value of such loans may not necessarily be the same as the loan amount, and IAS 39.43 requires both parties to initially record the asset or liability at fair value (plus directly attributable transaction costs for items that will not be measured at fair value subsequently). IAS 39.49 also requires that, for this purpose, the fair value of a financial liability with a demand feature is not less than the amount repayable.

Given that there is no active market for inter-company loans, fair value will usually need to be estimated. IAS 39 AG 64 indicates that the appropriate way to do this is to determine the present value of future cash receipts using a market rate of interest for a similar instrument.

The difference between fair value and loan amount then needs to be accounted for. Where the loan is from a parent to a subsidiary, it would be inappropriate to recognise a gain or loss for the discount or premium; in substance this is an additional contribution by the parent (or a return of capital/distribution by the subsidiary). Contributions from and distributions to "equity participants" do not meet the basic definition of income or expenses (Framework 70).

Where the loan is between group entities other than a parent and subsidiary, the discount or premium may meet the definition of income or expense depending on whether or not, in substance, the transaction is carried out at the behest of the parent.

Where the loan documentation does not state any date for repayment, it is necessary to ascertain the expected repayment pattern to determine the appropriate accounting. Given that the timing of repayment will usually be in accordance with the parent's wishes, it should be possible in most cases for the parent/lender to make a sufficiently reliable estimate. If repayment is indeterminable, this is probably because either:

- the parent/lender has no current or foreseeable intention to recall the loan, which indicates that it is substance a capital contribution; or
- the subsidiary/borrower is currently unable to repay, which indicates possible impairment.

This discussion is relevant only to the separate financial statements. On consolidation the inter-company loans will be eliminated, including any discount or premium to fair value.

Detailed guidance

Inter-company loans meet the definition of financial instruments and are therefore within the scope of IAS 39. IAS 39.43 requires that financial instruments are initially recognised at fair value.

Where inter-company loans are made on normal commercial terms, no specific accounting issues arise and the fair value at inception will usually equal the loan amount.

Where the loan is not on normal commercial terms, the required accounting depends on the terms, conditions and circumstances of the loan. It is therefore necessary to ascertain the terms and conditions, which may not be immediately apparent if the loan documentation is not comprehensive.

1 Loans forming part of the net investment in a subsidiary

Parent entities sometimes make loans to subsidiaries that, in substance, form part of the net investment in the subsidiary ie settlement is neither planned nor likely in the foreseeable future. If the loan is perpetual (ie not repayable at all), or repayable only at the discretion of the subsidiary, the subsidiary records the proceeds as a component of equity. This is sometimes termed a capital contribution. No discounting or amortisation is required. If the loan is repayable at the discretion of the parent (ie it contains a demand feature), the subsidiary should record the full loan amount as a liability (IAS 39.49).

The parent company should record the loan as part of its investment in the subsidiary. (Strictly, the loan is recorded at fair value, which is estimated by discounting the future loan repayments using a market rate. The discount (ie difference between the loan amount and fair value) is then recorded as part of the parent's cost of investment in the subsidiary. However, for perpetual loans, or other loans for which repayment is neither planned nor likely in the foreseeable future, the discount will be 100% of the loan amount and the fair value of the loan itself is zero. Hence, the effect of recording the discount as part of the parent's investment is equivalent to recording the entire loan as part of the parent's investment.)

2 Short-term loans

Loans that are expected to be repaid in the near future should be recorded at the loan amount by both parties. The loan amount is likely to be a sufficiently close approximation to fair value. Inter-company current accounts or balances arising from cash pooling (or sweep) arrangements might fall into this category.

3 Fixed term loans - from parent to subsidiary

Fixed term inter-company loans should be recognised initially at fair value, estimated by discounting the future loan repayments using a rate based on the rate the borrower would pay to an unrelated lender for a loan with similar conditions (amount, term, security etc). The estimated future loan repayments will usually be the same as the contractual loan provisions, but this may not always be the case. .

Where the loan is from a parent to a subsidiary the difference between the loan amount and the fair value (discount or premium) should be recorded as:

- an investment in the parent's financial statements (as a component of the overall investment in the subsidiary);
- a component of equity in the subsidiary's financial statements.

Subsequently, the loan should be measured at amortised cost, using the effective interest method. This involves "unwinding" the discount such that, at repayment, the carrying value of the loan equals the amount to be repaid. The unwinding of the discount should be reported as interest income or expense.

Estimates of repayments should be evaluated in future periods and revised if necessary; the effect of a change in estimate should be:

- treated as an adjustment to the cost of investment by the parent/lender; and
- treated as an additional contribution (or distribution) by the subsidiary/borrower.

4 Loans with no stated date for repayment

Loans within a group are sometimes made without stated repayment terms. In such cases, it will be necessary for management to determine the appropriate accounting based on the expected timing of repayments. However, if the loan is repayable on demand the subsidiary (borrower) should record the full loan amount as a liability. Otherwise:

- if the intention is to make the loan available indefinitely, the guidance in 1.above should be applied;
- if the intention is that the loan will be short-term, the guidance in 2.above should be applied;
- if the loan is intended to be made available for a longer period but timing is uncertain, the accounting should be based on management's best estimate of future cash flows. The accounting will then follow the same approach as for a fixed term loan (ie discounting to present value on initial recognition). Estimates of repayments should be evaluated in future periods and revised if necessary; the effect of a change in estimate should be:
  - treated as an adjustment to the cost of investment by the parent/lender; and
  - treated as an additional contribution or a distribution by the subsidiary/borrower.

5 Loans between fellow subsidiaries

Where the loan is made between fellow subsidiaries any initial difference between loan amount and fair value should usually be recorded in profit or loss by both subsidiaries. As in the other scenarios, however, if the loan contains a demand feature it should be recorded at the full loan amount by the borrower.

In some circumstances it will be clear that the transfer of value from one subsidiary to the other has been made under instruction from the parent company. In these cases, an acceptable alternative treatment is to for any gain on initial recognition to be recorded as a credit to equity (capital contribution) and for any loss to be recorded as a distribution (debit to equity).

6 Loan from subsidiary to parent

Where a loan is made by a subsidiary to its parent, any initial difference between loan amount and fair value should usually be recorded:

- as a distribution by the subsidiary; and
- as income by the parent to the extent the distribution is made out of post-acquisition accumulated profits of subsidiary. To the extent any distribution is made out of pre-acquisition profits, the amount is recorded as a reduction of the cost of investment, assuming the parent applies the cost method of accounting for that investment (IAS 27.4).

If the loan contains a demand feature, it should, as in other scenarios, be recorded at the full loan amount by the parent (borrower).

7 Impairment

In all cases it will be necessary for the lender to assess whether there is objective evidence that its financial asset is impaired (IAS 39.58). If all or part of the loan is, in substance, part of the parent's net investment, the total investment should be assessed.

8 Related party disclosures

Inter-company loans meet the definition of related party transactions in IAS 24.9 and the disclosures required by IAS 24.12 - 22 must be given in sufficient detail to enable the effect of the loans on the financial statements to be understood. Where there are significant uncertainties, such as the expected terms of a loan, the disclosures should refer to this.

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Given that there is no active market for inter-company loans, fair value will usually need to be estimated. IAS 39 AG 64 indicates that the appropriate way to do this is to determine the present value of future cash receipts using a market rate of interest for a similar instrument.

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Where the loan is between group entities other than a parent and subsidiary, the discount or premium may meet the definition of income or expense depending on whether or not, in substance, the transaction is carried out at the behest of the parent.

Where the loan documentation does not state any date for repayment, it is necessary to ascertain the expected repayment pattern to determine the appropriate accounting. Given that the timing of repayment will usually be in accordance with the parent's wishes, it should be possible in most cases for the parent/lender to make a sufficiently reliable estimate. If repayment is indeterminable, this is probably because either:

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Example

Parent company (P) makes a three year interest-free loan of $100 to its subsidiary (S) on 31 December 20X0. The borrowing rate available to S in the market is 8%. The entries in P's and S's **separate financial statements** are as follows.

Initial recognition

The fair value of the future cash flows is $79 (calculated as $100 discounted at 8% over three years). The substance of the arrangement comprises a capital contribution or equity component of $21, and a fair value receivable/payable element of $79. The following entries are recorded by the parent and the subsidiary on 31 December 20X0:

	Parent		Subsidiary	
	Dr	Cr	Dr	Cr
Cash		100	100	
Investment S	21			
Receivable from S	79			
Payable to P				79
Equity (capital contribution)				21

Unwinding of discount in years 20X1, 20X2 and 20X3

In years 1, 2 and 3 the discount is "unwound" using the 8% interest rates, giving cumulative interest income/expense of $ 21 ($6.5, $7.0 and $7.5 in years 1 to 3 respectively):.

	Parent		Subsidiary	
	Dr	Cr	Dr	Cr
Interest income/expense		21	21	
Receivable from S	21			
Payable to P				21

Repayment

The entries to record repayment of $100 at 31 December 20X3 are:

	Parent		Subsidiary	
	Dr	Cr	Dr	Cr
Cash	100			100
Receivable from S		100		
Payable to P			100	

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