

Advisor alert—*IFRS Viewpoint*— *Related party loans at below-market interest rates*

November 2015

Overview

The Grant Thornton International IFRS team has published *IFRS Viewpoint—Related party loans at below-market interest rates*.

The *IFRS Viewpoint* series provides insights on applying IFRS in challenging situations. Each edition will focus on an area where the Standards have proved difficult to apply or lack guidance.

This edition provides a framework for accounting for loans made by an entity to a related party that are at below-market levels of interest. Common examples of such loans include:

- Inter-company loans (in the separate or individual financial statements),
- Employee loans.

The issue

Loans are one type of financial instrument. As such they are governed by IFRS 9 (2014) *Financial Instruments* which requires all financial instruments to be initially recognized at fair value. This can create issues when loans are made at below-market rates of interest, which is often the case for loans to related parties.

Normally the transaction price of a loan (i.e. the loan amount) will represent its fair value. For loans made to related parties however,

this may not always be the case as such loans are often not on commercial terms. Where this is the case, the fair value of the loans must be calculated and the difference between fair value and transaction price accounted for. This *IFRS Viewpoint* provides a framework for analyzing both the initial and subsequent accounting for such loans.

Resource

The publication *IFRS Viewpoint—Related party loans at below-market interest rates* follows this *Advisor alert*.

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IFRS Viewpoint

Related party loans at below-market interest rates

Our 'IFRS Viewpoint' series provides insights from our global IFRS team on applying IFRSs in challenging situations. Each edition will focus on an area where the Standards have proved difficult to apply or lack guidance. This edition provides a framework for accounting for loans made by an entity to a related party that are at below-market levels of interest. Common examples of such loans include:

- inter-company loans (in the separate or individual financial statements)
- employee loans.

What's the issue?

Loans are one type of financial instrument. As such they are governed by IFRS 9 (2014) 'Financial Instruments' which requires all financial instruments to be initially recognised at fair value. This can create issues when loans are made at below-market rates of interest, which is often the case for loans to related parties.

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related parties however, this may not always be the case as such loans are often not on commercial terms. Where this is the case, the fair value of the loans must be calculated and the difference between fair value and transaction price accounted for. This IFRS Viewpoint provides a framework for analysing both the initial and subsequent accounting for such loans.

Relevant IFRSs

IFRS 9 (2014) Financial Instruments
IFRS 2 Share-based Payment
IAS 24 Related Party Disclosures
IAS 19 Employee Benefits



Our view

Where related party 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 a loan is not on normal commercial terms however, the 'below-market' element of the transaction needs to be evaluated and separately accounted for.

Practical insight: What are normal commercial terms?

Normal commercial terms include the market interest rate that an unrelated lender would demand in making an otherwise similar loan to the borrower. This interest rate would reflect the borrower's credit risk, taking into account the loan's ranking and any security, as well as the loan amount, currency duration and other factors that would affect its pricing.

The diagramme illustrates the framework we believe should be applied in analysing such questions. The first step is to determine whether the loan is on normal commercial terms. If not, this indicates that part of the transaction price is for something other than the financial instrument and should therefore be accounted for independently from the residual amount of the loan receivable or payable. This separate element should be accounted for under the most relevant Standard. For example, in the case of a

loan to an employee that pays interest at a rate less than the market rate, the difference between the loan amount and fair value is, in substance, an employee benefit that should be accounted for under IAS 19.

Where the 'below-market' element of the loan is not directly addressed by a Standard, reference should be made to the IASB's Conceptual Framework for Financial Reporting (the Conceptual Framework) in determining the appropriate accounting. For example, for

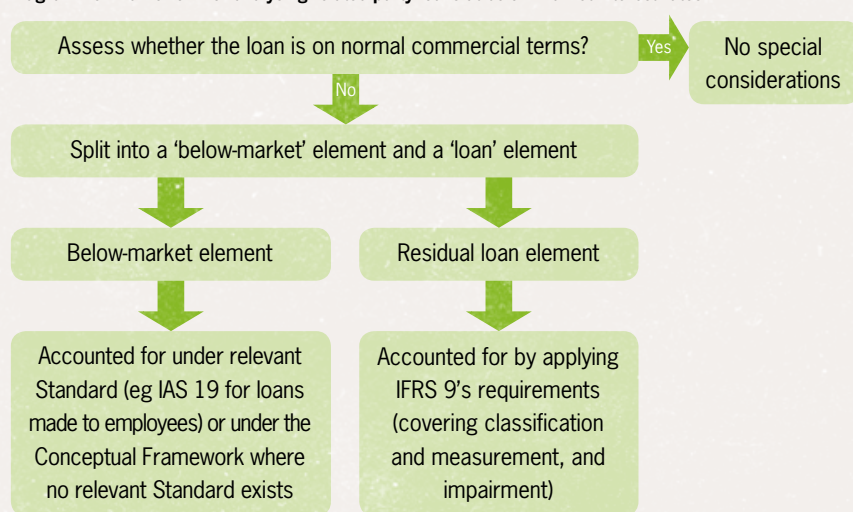
reasons we will explain, in the case of a loan from a parent to a subsidiary that pays interest at less than the market rate, the difference between the loan amount and the fair value (discount or premium) will typically be recorded as

- an investment in the parent's separate financial statements (as a component of the overall investment in the subsidiary)
- a component of equity in the subsidiary's individual financial statements (sometimes referred to as a 'capital contribution').

Having separately accounted for this element of the loan, the remaining loan receivable or payable should be accounted for under IFRS 9. IFRS 9 sets out the classification and measurement requirements for the loan receivable or payable as well as the impairment requirements for the receivable.

The remainder of this IFRS Viewpoint discusses these issues in more detail.

Diagramme: Framework for analysing related party loans at below-market interest rates



More analysis

Is the loan on normal commercial terms?

IFRS 9 requires all financial instruments to be measured on initial recognition at fair value. This will normally be the transaction price in a transaction between unrelated parties. If a loan is made on normal commercial terms (both in terms of principal and interest), no specific accounting issues arise and the fair value at inception will usually equal the loan amount.

This may not always be the case however – especially for loans to related parties. Such loans are often not on normal commercial terms. An entity making a loan to a related party such as another entity within a group or an employee should therefore evaluate whether the loan has been made on normal commercial terms. We think it is useful to make a distinction between on-demand or short-term loans and longer fixed term loans in doing this:

Short-term and on-demand loans to related parties

In our view loans that are expected to be repaid in the near future should generally be recorded at the loan amount by both parties (subject to IFRS 9's impairment requirements). We believe the loan amount is likely to be a sufficiently close approximation to fair value in most such cases. Inter-company current accounts or balances arising from cash pooling (or sweep) arrangements might fall into this category.

Fixed term loans to related parties

Additional analysis may be needed for a longer-term loan to a related party such as a subsidiary.

On initial recognition the fair value of loans to related parties can be estimated by discounting the future loan repayments using the rate the borrower would pay to an unrelated lender for a loan with otherwise similar conditions (eg amount, duration, currency, ranking and any security). The estimated future loan repayments will usually be the same as the contractual loan provisions, but this may not always be the case.

Loans with limited stated documentation

Sometimes loan agreements between a parent and subsidiary will lack the level of detail and documentation of commercial lending agreements. In such circumstances, the parties may need to take additional steps to clarify (and document) their rights and obligations under the agreement in order to determine the appropriate accounting. This might include obtaining legal advice if necessary.

It is worth noting that in some parts of the world (eg South Africa), loans without stated repayment terms are deemed to be legally payable on demand under the local law. If so, the loan should be accounted for as an on-demand asset or liability (see guidance). Even in the absence of legislation, loans without stated repayment terms are often deemed to be payable on demand due to the nature of the parent and subsidiary relationship whereby the parent can demand repayment as a result of the control it exercises over the subsidiary.

In practice, a parent may provide some form of assurance that it does not intend to demand repayment of a loan to a subsidiary within a certain timeframe despite having the contractual right to do so. This assurance may be provided verbally, via a comfort letter or as an amendment or addendum to the contract. In our view, amendments to the contract should be reflected in the accounting for the loan asset or liability while non-binding assurances should not (although they should be considered as part of the impairment assessment). Legal advice may need to be obtained to make that distinction.

Split the loan into the below-market element and the residual loan element

If the loan amount does not represent fair value, we believe the loan should be split into the element that represents the below-market element of the loan and the remainder of the loan that is on market terms.

Accounting for the below-market element

Where a loan to a related party is not on normal commercial terms, the substance of the below-market element should be ascertained. The substance will then determine the accounting for this part of the loan receivable. The most relevant Standard should be applied to this part of the loan. If there is no relevant Standard, reference should be made to the general concepts in the Conceptual Framework in order to reflect the substance of this part of the loan. We illustrate this process by a number of examples, considering inter-company loans first and then loans to employees:

Inter-company loans (in the separate or individual financial statements)

The accounting for the below-market element of an inter-company loan in the separate or individual financial statements of the entities is not addressed by a specific Standard. As a result we approach the accounting for such

transactions by applying the principles set out in the Conceptual Framework, in particular its definitions of assets, liabilities and equity. We consider below the effect of this in accounting for the below-market element relating to the following types of inter-company loans:

- fixed term loan from a parent to a subsidiary
- loans between fellow subsidiaries
- loans from subsidiaries to parent
- loans to related parties that are not repayable.

Fixed term loan from a parent to a subsidiary

Where a loan is made by a parent to a subsidiary and is not on normal commercial terms, we believe the difference between the loan amount and its fair value should be recorded as:

- an investment in the parent's separate financial statements (as a component of the overall investment in the subsidiary)
- a component of equity in the subsidiary's individual financial statements (this is sometimes referred to as a capital contribution).

This is consistent with the principles set out in the Conceptual Framework which defines income as "increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants". The definition of expenses similarly excludes distributions to equity participants. If a loan is made by a parent to a subsidiary on favourable terms, the substance of the transaction is that the subsidiary has received a contribution from the parent to the extent that the cash advanced exceeds the fair value of the subsidiary's financial liability. Under the Framework this contribution is not income. This thinking also underpins the way in which we account for the below-market element of other inter-company loans.



Loans between fellow subsidiaries

Where a loan is made between fellow subsidiaries, additional analysis may be needed.

As in the other situations described above, the entities involved should assess whether the facts and circumstances indicate that part of the transaction price is for something other than the financial instrument. If it is, then the fair value of the financial instrument should be measured. Any difference between the fair value and the amount actually lent will often be recognised in profit or loss in accordance with IFRS 9's general guidance in this area (IFRS 9 contains specific guidance on when such 'day 1' gains or losses should be recognised in profit or loss).

In some circumstances however 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, we believe an acceptable alternative treatment is to record any difference as a credit to equity (capital contribution) and for any loss to be recorded as a distribution (debit to equity).

Loans from subsidiary to parent

Where a loan is made by a subsidiary to its parent on terms that are favourable to the borrower, we believe any initial difference between loan amount and fair value should usually be recorded:

- as a distribution in the subsidiary's individual financial statements and
- as income in the parent's separate financial statements.

Distributions received from a subsidiary will usually be recognised in profit or loss in the parent's separate financial statements (an exception would be where the distribution clearly represents a repayment of part of the cost of the investment). Depending on the circumstances, the parent entity may also need to consider whether the distribution is an indicator of impairment in the investment in the subsidiary (interests in subsidiaries are generally outside the scope of IFRS 9 and therefore subject to the requirements of IAS 36 'Impairment of Assets').

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

Loans to related parties that are not repayable

Sometimes in a group situation, a parent may make an advance to a subsidiary (the advance may or may not be termed a 'loan') whereby the contractual terms state that the amount:

- is not repayable or
- is repayable at the discretion of the subsidiary in all circumstances (other than on liquidation).

In our view, this advance should be recorded as equity by the subsidiary (no discounting or amortisation is necessary) and as part of the net investment in the subsidiary by the parent (sometimes referred to as a 'capital contribution') for the same reasons as outlined in the section on 'fixed term loans from a parent to a subsidiary' above.



Loans to an employee

In contrast to the accounting for the below-market element of inter-company loans, we believe the treatment of the below-market element of a loan to an employee is addressed by specific Standards. We expand on this by considering below the effect of a below-market element for the following types of loans to employees:

- loans to employees generally
- loans to an employee linked to the entity's shares
- forgivable loans.

Loans to employees generally

Where an entity makes a loan to an employee that is not on normal commercial terms, our view is that the initial difference between the transaction price of the loan and its fair value represents an employee benefit.

IAS 19 should therefore be applied to the initial difference or non-financial element of the loan. In applying IAS 19, our view is:

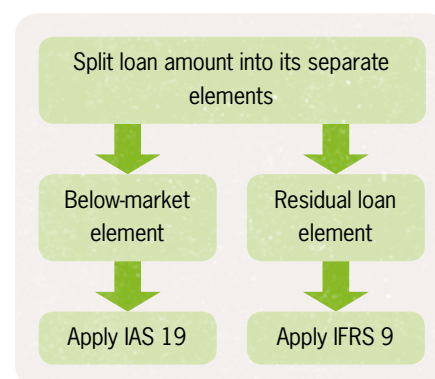
- if the benefit (ie the favourable terms of the loan) is not dependent on future service by the employee, it should be recorded as an employee benefit expense when the loan is advanced

- if benefit is linked to future employee service, the initial difference should be recognised as an expense over the service period. The 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
 - the interest actually charged to the employee.

Examples of situations in which the benefit is linked to future employee service include loans that:

- are repayable if the employee leaves within a certain period or
- revert to a market interest rate if the employee leaves within a certain period.

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. Accordingly IAS 19 requires an expense to be recognised when the employee provides services.



The allocation of the employee benefit expense under IAS 19 depends (amongst other things) on whether the benefit is considered long-term or short-term. 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. However, some arrangements might have conditions or features that make them long-term in nature.



Under short-term benefit accounting, the entity should recognise the undiscounted expense payable in exchange for employee services in each period. As discussed above, 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 IFRS 9's amortised cost using the effective interest rate method
- the interest payable by the employee.

Other methods of allocation might also be acceptable.

Loans to an employee 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, and which is secured only over those shares, may in substance represent the grant of a share option. A number of issues can arise in such situations, which are beyond the scope of this publication.

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.

Accounting for the residual loan element

Having separated the 'below-market' element of the transaction, the remaining part of the loan receivable is accounted for as a financial instrument under IFRS 9. Accordingly, the entity that has granted the loan will need to consider that Standard's requirements on:

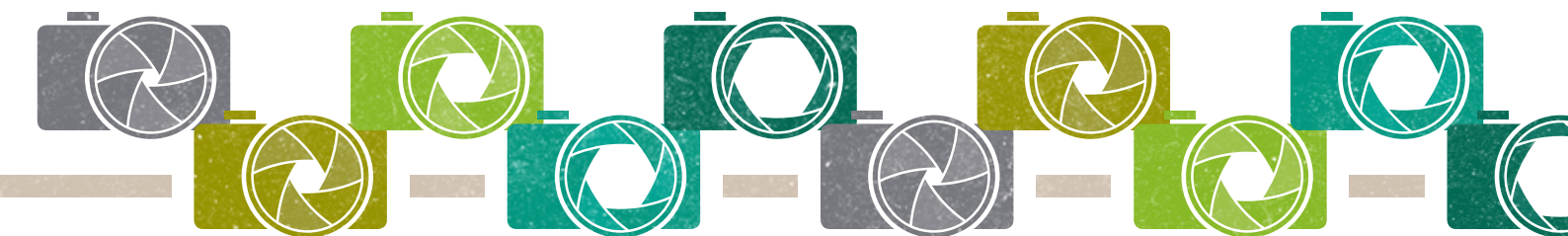
- classification and measurement (in particular the impact of any complex loan terms on the 'solely payments of principal and interest' classification test)
- impairment, including the recognition of expected credit losses.

Where there is a change to the terms of a loan to a related party at a below-market rate of interest, IFRS 9's requirements on derecognition, including the guidance on modifications will also need to be considered.

More detailed information on these requirements can be found in our September 2014 Special Edition of IFRS News on 'IFRS 9 (2014)'.

Related party disclosures

Both inter-company loans and loans to employees meet IAS 24's definition of related party transactions and the disclosures required by that Standard must therefore 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.



Examples

Loan to a subsidiary at below-market interest rate

Parent company (P) makes a three year interest-free loan of CU100 to its subsidiary (S) on 31 December 20X0. The borrowing rate available to S in the market is 8%. The approach to be taken in accounting for the loan and the entries to be recorded in P's and S's separate financial statements are as follows:

Step 1: Assess whether the loan is on normal commercial terms

The loan is not on normal commercial terms as it pays no interest in contrast to a loan on market terms which would pay 8%. It is therefore necessary to proceed to step 2.

Step 2: Split the loan into the below-market element and the loan element

The fair value of the financial element can be computed by discounting the future cash flows of CU100 at the market rate of 8% over three years, giving a figure of CU79. The difference between this amount and the CU100 transaction price of the loan is CU21 which represents the non-financial element of the loan.

Step 3: Account for the below-market element

The substance of the below-market element is a capital contribution by the parent to the subsidiary, leading to the following entries being recorded by the parent and the subsidiary on 31 December 20X0 in their separate or individual financial statements:

	Parent		Subsidiary	
	Debit (CU)	Credit (CU)	Debit (CU)	Credit (CU)
Investment in S	21			
Cash		21	21	
Equity (capital contribution)				21

No further entries will be required in future periods in respect of this element of the loan.

Step 4: Account for the residual loan element

The remaining part of the loan, representing the fair value of the financial element of the loan on initial recognition is recorded as follows:

	Parent		Subsidiary	
	Debit (CU)	Credit (CU)	Debit (CU)	Credit (CU)
Receivable from S	79			
Cash		79	79	
Payable to P				79

Subsequent accounting:

Assume for the purposes of the example, that the loan qualifies for amortised cost accounting. In subsequent periods it will be necessary to unwind the discount (the figure of CU21 in the example) using the 8% effective interest rate (the rate that exactly discounts estimated future cash payments through the life of the financial asset to its gross carrying amount). This results in cumulative interest income/expense of CU21 (CU6.5, CU7.0 and CU7.5 in years 1 to 3 respectively):

	Parent		Subsidiary	
	Debit (CU)	Credit (CU)	Debit (CU)	Credit (CU)
Interest income/expense		21	21	
Receivable from S	21			
Payable to P				21

Having first done this, it will then be necessary for the parent company to recognise expected credit losses (IFRS 9 is clear that the effective interest rate is applied to the gross carrying amount of a financial asset – the amortised cost of a financial asset, before adjusting for any loss allowance). Assume for the purpose of the example that the financial element of the loan receivable does not deteriorate significantly in credit quality subsequent to its initial recognition and that 12-month expected credit losses are recognised as opposed to lifetime expected credit losses.

What are '12-month expected credit losses'?

- 12-month expected credit losses are a portion of the lifetime expected credit losses
- they are calculated by multiplying the probability of a default occurring on the instrument in the next 12 months by the total (lifetime) expected credit losses that would result from that default
- they are not the expected cash shortfalls over the next 12 months. They are also not the credit losses on financial instruments that are forecast to actually default in the next 12 months.

The lifetime expected credit losses are estimated to be CU3 at the end of year 1. This is revised to CU1.5 at the end of year 2, with the loan finally being repaid in full at the end of year 3.

20X1 – recognition of expected credit losses

	Parent	
	Debit (CU)	Credit (CU)
Impairment loss (profit or loss)	3	
Receivable from S		3

20X2 – change in expected credit losses

	Parent	
	Debit (CU)	Credit (CU)
Impairment loss (profit or loss)		1.5
Receivable from S	1.5	

20X3 – change in expected credit losses

	Parent	
	Debit (CU)	Credit (CU)
Impairment loss (profit or loss)		1.5
Receivable from S	1.5	

20X3 – repayment of loan

	Parent		Subsidiary	
	Debit (CU)	Credit (CU)	Debit (CU)	Credit (CU)
Cash	100			100
Receivable from S		100		
Payable to P			100	



Loan to employee at below-market level of interest

An entity makes a 5 year, interest-free loan of CU10,000 to an employee. The loan remains available whether or not the employee remains in service. The market rate for a similar loan is 10%.

Step 1: Assess whether the loan is on normal commercial terms

The loan is at a favourable rate of interest for the employee and is therefore not on normal commercial terms. It is therefore necessary to proceed to step 2.

Step 2: Split the loan into its below-market element and the loan element

The fair value of the loan is estimated based on the future cash flow (CU10,000 in five years' time) and the market interest rate (10%). This amount of CU6,209 represents the financial element of the loan. The balance of CU3,791 represents the below-market element of the loan.

Step 3: Account for the below-market element of the loan

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 CU3,791 is therefore recognised as an expense at the date of the loan. The combined journal entries for Steps 2 and 3 are as follows:

	Debit (CU)	Credit (CU)
Cash		10,000
Loans and receivables	6,209	
Employee benefit expense	3,791	

Step 4: Account for the residual loan element

The remaining part of the loan is accounted for under IFRS 9. Assume that the asset qualifies for amortised cost measurement. Accordingly it will be measured using the effective interest rate of 10% and expected credit losses will need to be considered as in Example 1 above.





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