BY
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Directors and Intercompany Loans FRS 102 & the Companies Act 2014

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Maureen Kelly, CPA Ireland outlines the impact of FRS 102 on Directors and Intercompany loans.

The treatment of Directors loans and intercompany loans under FRS 102 has been the cause of much discussion since the Standard was first issued as, in general, they are interest free loans and now their treatment has changed.

Under previous Irish GAAP most entities held these loans at face value on the Balance Sheet and left them there until settlement.

Under FRS 102 lending arrangements which are financed at an interest rate that is lower than the market rate or even interest free are considered to be financing transactions. It sets out separate accounting requirements for financing transactions which in essence require that the loan is measured as if it was a loan with a market rate of interest.

These loans are classified as ***Basic Financial Instruments*** under Section 11. Paragraph 11.13 of FRS 102 sets out the initial measurement requirements for an arrangement which is a financing transaction. It is measured at the present value of the future cash payments discounted at a market rate of interest for a similar debt instrument. Subsequent measurement is at amortised cost using the effective interest method which is determined in accordance with the requirements of paragraphs 11.16 to 11.20 of FRS 102. Assuming that the original effective interest rate as determined at the time of the initial recognition of the loan is a fixed rate of interest, the rate is not updated for subsequent changes to the market rate of interest. The following example demonstrates this treatment.

On 01/01/15 Subsidiary Co. took a €1m interest free 5 year fixed term loan from its parent company. Assume effective interest rate 4%.

	Opening value €	Effective Interest €	Closing value €
2015	821,927	32,877	854,804
2016	854,804	34,192	888,996
2017	888,996	35,560	924,556
2018	924,556	36,982	961,538
2019	961,538	38,462	1,000,000

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the loan to its carrying amount at initial recognition.

You will note a difference (€178,073) arises between the amount of cash received or advanced and the present value of the loan. This difference reflects that the lender has made a loan at a lower than market rate of interest and thereby has provided an additional benefit to the borrower. FRS 102 does not set out specific accounting requirements for that difference. To determine the accounting treatment for the difference we need to assess the particular facts and circumstances of each arrangement.

Intercompany loans

If the loan is from a Parent to its Subsidiary the lender is in its capacity as the owner is effectively making an additional investment in the subsidiary.

Parent's Books	€	Subsidiary's Books	€
Dr Loan receivable from subsidiary	821,927	Dr Bank	1,000,000
Dr Investment in subsidiary	178,073	Cr Loan repayable to parent	821,927
Cr Bank	1,000,000	Cr Capital contribution (equity)	178,073

If the loan is between related parties where one owns the other or the lender and the borrower are owned by the same person the difference arising on initial recognition would be accounted for as a distribution or capital contribution.

If the loan is from a Subsidiary to its Parent

Subsidiary's Books	€	Parent's Books	€
Dr Loan receivable from parent	821,927	Dr Bank	1,000,000
Dr Distribution to parent (equity)	178,073	Cr Loan repayable to sub	821,927
Cr Bank	1,000,000	Cr Distribution from sub (P&L)	178,073

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If the loan is between fellow subsidiaries or other entities owned by the same person

Lending Subsidiary	€	Borrowing Subsidiary	€
Dr Loan receivable from other sub	821,927	Dr Bank	1,000,000
Dr Distribution (equity)	178,073	Cr Loan repayable to other sub	821,927
Cr Bank	1,000,000	Cr Capital contribution (equity)	178,073

Directors loans

If the loan is between the company and its director it will depend on whether the loan is made in the director's capacity as a shareholder or as a staff benefit.

Loan to the Company from its Director (in their capacity as a shareholder) in Companies books

	€
Dr Bank	1,000,000
Cr Loan repayable to director	821,927
Cr Capital contribution (equity)	178,073

Loan to the Director (in their capacity as a shareholder) from the Company in Companies books

	€
Dr Loan receivable from director	821,927
Dr Distribution to director (equity)	178,073
Cr Bank	1,000,000

Loan to the Director from the Company (staff benefit) in Companies books

	€
Dr Loan receivable from director	821,927
Dr Deferred remuneration	178,073
Cr Bank	1,000,000

Subsequent measurement

After initial recognition interest is accounted for applying the effective interest method (as in above example). The entity receiving interest records it as an income, which is recorded in total comprehensive income, either in profit or loss or in other comprehensive income. If the interest income is considered a realised profit it is recorded in profit or loss, otherwise it is recorded in other comprehensive income. The entity paying interest records it as an expense in profit or loss.

Year ended 31/12/2015

Parent's Books	€	Subsidiary's Books	€
Dr Loan receivable from subsidiary	32,877	Dr Interest Expense	32,877
Cr Interest Income	32,877	Cr Loan repayable to parent	32,877

Realised/unrealised profit

So now we must consider whether the interest received is a realised or unrealised profit in order to decide where it should be recorded. Section 276 (1) of the Companies Act 2014 (CA2014) states that "realised profits, in relation to a company's entity financial statements, are references to such profits of the company as fall to be treated as realised profits for the purposes of those financial statements in accordance with principles generally accepted with respect to the determination for accounting purposes of realised profits at the time when those financial statements are prepared." And paragraph 14(a) of Schedule 3 states "only profits realised at the financial year end date shall be included in the profit and loss account"

Tech 02/10 3.3 from ICAEW states that, "It is generally accepted that profits shall be treated as realised for the purpose of applying the definition of realised profits in companies legislation only when realised in the form of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty." This technical release from ICAEW also has guidance on what elements of the above transactions they consider to be realised and unrealised profits. But this should be read taking into consideration that this advice is based on UK legislation.

We do still have the option of avoiding the above entirely by including in the terms of the loan that it is "payable on demand". The Standard states that debt instruments that are payable or receivable within one year are measured at the undiscounted amount of the cash or other consideration expected to be paid or received.

Companies Act 2014

Consideration should also be given to the requirements of Section 307 of the Companies Act 2014 for loans made to any director of the company by the company. The reconciliation of movements between the opening and closing values at the beginning and end of the financial year for both the current and prior year is more detailed than before, with the aggregate values being required for such movements to the extent possible, interest rates, maximum outstanding etc.

It is also recommended that the terms of loans to directors are in writing as Section 236 states that unless unambiguously evidenced in writing a loan by a company to a Director is due on demand and interest at 5% is due.

Conclusion

As the accounting treatment of the difference created by the implementation of FRS 102 is not specified, we as Accountants once again need to use our professional judgement to assess the particular facts and circumstances of each arrangement in deciding the most appropriate treatment whilst taking into consideration all legal and regulatory requirements. As with all such decisions it is recommended that the basis for the conclusion arrived at is documented.