

# *Accounting for interest-free or low-interest receivables and payables*

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As Tanzania adopts International Financial Reporting Standards (IFRS), one of the issues that are likely to face many companies is the issue of accounting for interest-free or low-interest receivables and payables. Most companies have significant low-interest or interest-free loans from their parent or sister companies abroad. The accounting requirements for these loans under IFRS are quite different from the previous accounting framework, Tanzania Financial Accounting Standards (TFAS). In this paper, we will discuss the accounting requirements for interest-free or low-interest receivables and payables under IFRS and look at some practical challenges that companies may face in accounting for interest-free or low-interest receivables and payables.

## **Accounting requirements**

Loans and receivables are financial instruments, which are accounted for in accordance with IAS 39. Similarly, accounts payable are financial instruments, which are included within the scope of IAS 39. IAS 39 paragraph 43 states that “When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.”

Subsequent to initial recognition accounts receivable are measured at amortised cost using the effective interest method. Financial liabilities are subsequently measured at amortised cost using the effective interest method, except for financial liabilities at fair value through profit or loss.

From the above paragraphs, it is clear that regardless of how financial assets and financial liabilities are subsequently measured, **they have to be recorded at fair value on initial recognition**. This requirement raises the following question - what is the fair value at inception of interest-free or low-interest accounts receivable and liabilities? This is the question that I will discuss in this issue of Keeping Pace with IFRS. However, before discussing this question, let us first look at what amortised cost is.

## **Amortised cost**

As explained above, subsequent to initial recognition accounts receivable are measured at amortised cost using the effective interest method, and all liabilities, other than liabilities carried at fair value through profit or loss, are also measured at amortised cost using the effective interest method.

IAS 39 defines the amortised cost of a financial asset or financial liability to be the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction for impairment or uncollectibility.

The above definition can be summarised as follows:

$$\text{Amortised cost} = \text{cash paid} - \text{principal repayments} +/- \text{Unamortised premiums or discounts} - \text{impairment}$$

Where there is no difference between the initial amount and the maturity amount, the amortised cost simply becomes **cash paid** minus **principal repayments** minus **impairment** and for liabilities this simply becomes **cash received** minus **principal repayments**.

### **Fair value of interest-free or low-interest receivables and liabilities**

IAS 39 AG64 states that the fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received). AG 64 also indicates that if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique.

For most accounts receivable and short term liabilities, the fair value at initial recognition would be the transaction price (i.e. cash given or received). The situation is, however, different for long-term receivables and liabilities that carry no interest. The fair value of these receivables and liabilities should be estimated as the present value of all future cash receipts/payments discounted using the prevailing market rate of interest for similar receivables or liabilities (IAS 39 AG64).

It should be remembered that fair values are only calculated and recognised once – at initial recognition only. In the subsequent accounting periods, these receivables and liabilities are accounted for at amortised cost.

### **Low-interest receivable**

Let us look at the following example:

On 1 January 2006, Mbega Tanzania Limited issued a five year loan of TShs 1,000,000 to its sister company, Mbega Kilimanjaro Limited. The loan bears interest of 10% payable annually. The market interest rate for a similar type of loan is 14%.

To record the above receivable, Mbega Tanzania Limited will first need to determine the fair value at 1 January 2006 (the date of initial recognition). This is because IAS 39 requires that all financial assets and financial liabilities should be measured at fair value on initial recognition. Because the above loan carries less than market interest rate, its value on 1 January 2006 will **not** be equal to the transaction price of TShs 1,000,000. The value will therefore need to be determined using valuation techniques as required by IAS 39 AG64. Mbega Tanzania Limited will therefore need to find the present value of the five year receivable of TShs 1,000,000 using a market interest rate of 14%. This will give a present value of TShs 862,677. The difference between cash given of Tshs 1,000,000 and the present value of TShs 862,677 will be expensed on initial recognition. The accounting entries on 1 January 2006 would therefore be as follows:

DR	Long term accounts receivable	862,677
DR	Profit and loss account	137,323
CR	Cash	1,000,000

The fair value adjustment of TShs 137,323, which will be expensed on initial recognition as indicated above, results into a discount of the same amount on the loan, which will need to be amortised over the period of the loan using effective interest of 14% to give a redemption value of TShs 1,000,000.

As indicated above, IAS 39 requires that subsequent to initial recognition, accounts receivable should be accounted for at amortised cost (not fair value). There will therefore be no need to determine the fair value of the loan at the end of the first year and during its remaining period to repayment.

On 31 December 2006, the amount of interest income, interest received and the loan balances will be as follows:

- Interest income will be TShs 120,775 (calculated as **Tshs 862,677 X 14%**)
- Interest received will be TShs 100,000 (calculated as **Tshs 1,000,000 X 10%**). Note that interest received is calculated based on cash given and contractual interest of 10%. This is the amount that Mbega Kilimanjaro Limited is contractually required to pay on yearly basis.
- Loan balance will be TShs 883,452 (calculated as **TShs 862,677+120,775-100,000**)

The accounting entries on 31 December 2006 would be as follows:

DR	Long term accounts receivable	120,775
CR	Profit and loss account	120,775
DR	Cash	100,000
CR	Long term accounts receivable	100,000

In the following four years, interest income, interest received and loan balance will be calculated in the same manner as indicated above. This will give us the following amortisation table:

<b>Year ending 31 December</b>	<b>Opening value</b>	<b>Interest income (14%)</b>	<b>Interest received (10%)</b>	<b>Closing balance</b>
2006	862,677	120,775	100,000	883,452
2007	883,452	123,683	100,000	907,135
2008	907,135	126,999	100,000	934,134
2009	934,134	130,779	100,000	964,912
2010	964,912	135,088	100,000	1,000,000

At the end of five years, the loan amount will have grown to the amount receivable from Mbega Kilimanjaro Limited of TShs 1,000,000. The final entry when the loan is repaid would therefore be:

DR	Cash	1,000,000
CR	Long term accounts receivable	1,000,000

The above entries will close the transaction in Mbega Tanzania Limited.

### **Low-interest liability**

In the above example, Mbega Kilimanjaro Limited will have received a low interest loan from its sister company, Mbega Tanzania Limited. The accounting treatment of this loan will be the same as above only that the entries will be on the opposite side. For example, on initial recognition of the loan, Mbega Kilimanjaro Limited will make the following entries:

DR	Cash	1,000,000
CR	Borrowings	862,677
CR	Profit and loss account	137,323

### **Interest-free interest receivables and liabilities**

Like low-interest receivables and liabilities, interest free receivables and liabilities will initially be measured at fair value and subsequently at amortised cost. The determination of fair values and the accounting entries will be as shown in the example above.

## **Staff loans**

It is common practice for companies to give interest-free or low-interest loans to staff. These loans need to be accounted for in terms of IAS 39 following the principles explained above. Again the determination of fair values and the accounting entries will be as shown in the example above. The only difference would be the fact that staff loans are normally repaid by instalment instead of a bullet payment at the end of the term. However, this does not change the principles explained above.

## **Some practical challenges**

In applying the above principle the following challenges are likely to be faced:

### **a) Loans with no repayment terms**

It is common in Tanzania for companies to receive interest free loans from their parent companies or sister companies abroad which do not have repayment terms. These loans pose a challenge in determining their fair values at initial recognition as it is not possible to apply the valuation techniques where there is no repayment date.

In accounting for such loans, there are suggestions that the loans are given for a long period of time and in essence form part of the equity. The suggestion therefore is to measure these loans at their transaction prices and thereby treat them as capital. This view cannot be supported by IAS 39 because there is a contractual obligation to repay these loans, which makes them liabilities. All liabilities need to be initially measured at fair value.

The other view is to treat these loans as demand loans. This view can be supported because if there are no specific repayment terms, the loan can be recalled at any time. The fair value of a demand loan at initial recognition is equal to its transaction price. If these loans are treated as demand loans, they will need to be reclassified from long term to current liabilities.

There is yet another problem with these loans. Most companies that receive these loans are financially weak and need a support from their holding or sister companies. If these loans are treated as demand loans, a number of these companies would not be going concerns. There is therefore a practice of these loans being subordinated in favour of other creditors of the company involved. In such cases, the loans cannot be treated as demand loans. Management will therefore need to establish the best estimate of the repayment date in order to determine the fair values on initial recognition.

**b) Errors in subsequent measurement of interest-free or low-interest receivables and liabilities**

There is a mistaken view that interest-free or low-interest receivables and liabilities need to be fair valued every year and the fair value gain or losses recorded in the profit and loss account. This is an incorrect application of IAS 39 rules, which results in misstatement in the financial statements. As explained above, financial assets and liabilities are only fair valued at initial recognition and are subsequently accounted for at amortised cost. The only exception to this rule is when the assets and liabilities were designated at inception as financial assets and liabilities at fair value through profit or loss.

Companies will therefore need to keep track of the amortised cost during the lives of all interest-free or low-interest receivables and liabilities subsequent to initial recognition. Experience has shown that most accounting systems do not have internal capabilities to generate and maintain amortisation tables. However, these schedules can be prepared using spreadsheets. Keeping manual records of amortisation schedules for companies that have large numbers of employees with interest-free or low-interest staff loans could be a big task.

**c) Interest free liabilities of a central bank**

Central banks hold certain interest-free deposits, which are driven by regulation. For example, commercial banks are required to deposit a certain percentage of their eligible liabilities with the central bank on an interest-free basis. A large part of these deposits are likely to continue in perpetuity so long as the financial system is still working and there is no change in the banking law. The total value of these deposits would change with the change in the regulation of the minimum cash deposit ratio and with the change in the value of the eligible liabilities of individual banking institutions.

As explained above, financial assets and liabilities should be measured at fair value on initial recognition. Normally, the fair value of a financial instrument on initial recognition is the transaction price. However, as we have seen in the example above, this presumption may be overturned if a different price is evidenced by regularly occurring market transactions. IAS 39 AG73 states that if a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. This is the reason that in the above example of Mbega Tanzania Limited we have used a market interest rate to determine the fair value of the accounts receivable.

Calculating the fair value of the regulatory driven interest free liabilities of a central bank may be a challenge since there is no market for arms length transactions for such liabilities, and therefore there could be no basis on which to overturn the use of the transaction price.

## **Conclusion**

This paper has discussed the accounting requirements for interest-free or low-interest receivables and payables. It should be noted that the accounting treatment for such instruments introduced by IAS 39 are quite different from the treatment under TFAS. It is therefore important for management to take note of the change and make sure that financial statements of their companies are properly adjusted to reflect the changes in the accounting treatment of accounts receivable and accounts payable. For any question or clarification please contact the author at the following email address: [michael.sallu@tz.pwc.com](mailto:michael.sallu@tz.pwc.com).