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ACCOUNTING FOR DIRECTORS' LOANS UNDER FRS 102

In this edition of a new series of views and commentary on FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Financial Reporting Faculty staff comment on some of the questions raised by members about accounting for directors' loans, taking account of member comments in response to recent faculty blogs on the issue. This Update was originally published in March 2016. This version has been updated for Tech 02/17BL *Guidance on the determination of realised profits under the Companies Act 2006* and the *Amendment to FRS 102 (May 2017): Directors' loans – optional interim relief for small entities*.

The context

Loans between a company and its directors are often made on an informal basis. Accordingly, there will not always be clear evidence regarding the agreed terms and conditions. In such circumstances, it is likely that the loan will be considered to be repayable on demand and thus classified as a current asset or current liability.

The accounting

If it can be determined that the loan is not repayable on demand or repayment has been formally deferred, the accounting classification will be different, with the loan classified as non-current ie, as a debtor or creditor due after more than one year. The classification will not be affected if the lender simply confirms a willingness to wait for repayment, as this does not change its entitlement to require repayment on demand. To avoid any uncertainty about the accounting, it makes sense to ensure, whenever possible, that the terms of any directors' loans are adequately documented.

Directors' loans that are repayable on demand will typically be measured at their nominal value, while any fixed term loans will typically be measured at amortised cost.

Where a loan has been provided interest free or at below market interest rates, FRS 102 generally requires the loan to be initially recorded at the present value of the future payments discounted at a market rate of interest for a similar debt instrument, and subsequently measured at amortised cost. Small entities have the option to measure a loan from a director who is a natural person and a shareholder in the small entity (or a close member of the family of that person) at transaction price[1].

[1] In May 2017 the FRC issued an *Amendment to FRS 102: Directors' loans – optional relief for small entities* which was effective immediately with retrospective application available. This amendment is an interim measure and is expected to be deleted and replaced with permanent requirements based on the proposals in FRED 67 *Draft amendments to FRS 102 – Triennial review 2017 – Incremental improvements and clarifications*, depending on the outcome of the consultation process.

When the loan is discounted it will be initially recognised at an amount lower than the transaction price (ie, the face value of the loan).The standard is silent on how the difference between these two amounts should be accounted for. Some guidance is, however, provided in the FRC's Staff Education Note 16 on financing transactions. Broadly speaking, the subsequent application of the amortised cost method will mean that the difference will unwind through the profit and loss account as a finance charge over the life of the loan.

When directors enter into such arrangements in their capacity as owners of the business (and the optional relief is not taken) it will make sense for the difference to be recognised directly in equity as a capital contribution or distribution. This is consistent with the treatment of loans between a parent and its subsidiary recommended in the ICAEW helpsheet on intercompany loans at non-market rates.

In other circumstances, the treatment of the difference will be a matter of judgement and will depend on the facts and circumstances of each case. For example, where an interest-free loan is made to a director to enable him or her to purchase a season ticket on terms available to other members of staff, it would seem appropriate to treat the difference as an employee benefit and account for it accordingly.

Examples of each of these scenarios are provided in the appendix to this Update.

The disclosures

FRS 102 states that, if there have been transactions between related parties[2], an entity should disclose the nature of the related party relationship as well as information about the transactions, outstanding balances and commitments necessary for an understanding of the potential effect of the relationship on the financial statements. At a minimum, disclosures must include:

- the amount of the transaction;
- the amount of outstanding balances, their terms & conditions and any guarantees given or received;
- provisions for uncollectible receivables related to the amount of outstanding balances; and
- the expense recognised during the period in respect of bad or doubtful debts due from related parties.

Section 413 of the Companies Act 2006[3] also contains disclosure requirements relating to advances and credits to directors. Companies are required to disclose details of:

- the amount;
- an indication of the interest rate;
- its main conditions;
- any amounts repaid;
- any amounts written off; and
- any amounts waived.

[2] Companies eligible for and choosing to apply the small company regime, and adopting Section1A Small Entities of FRS 102, are specifically required only to provide particulars of material transactions with directors that are not concluded under normal market conditions. However, further disclosures may be considered necessary to give a true and fair view.

[3] There are no exemptions available from these disclosures for small entities.

These disclosures, however, represent the minimum that should be provided. Other relevant facts and circumstances should be disclosed where this is necessary to enable users to fully understand the effect of the related party transactions or balances. Where loans are made at zero or below market interest rates, it may be necessary to include additional disclosures to enable users of the financial statements to appreciate the difference between the book value of the loans and the amount owing to or from the director.

Other ICAEW guidance

When considering the impact on distributable profits companies should refer to Tech 02/17BL *Guidance on the determination of realised profits under the Companies Act 2006*.

The faculty's FRS 102 Update *Loans from director-shareholders under the new UK GAAP* explains the rationale behind the accounting treatment and considers its practical implications.

APPENDIX A – WORKED EXAMPLES

EXAMPLE 1 – LOAN FROM DIRECTOR TO COMPANY

On 1 January 20X1, a director lends a company £1m at a zero rate of interest. The loan is repayable three years later. The market rate of interest for a similar loan is 5%. The entity does not qualify for the optional interim relief available to small entities in respect of directors' loans.

Under pre-FRS 102 UK GAAP, the company would simply record the loan at £1m and no interest would be recognised. However, under FRS 102 the amortised cost method must be applied, with the loan initially recognised at its present value of £1m/1.05^3 = £863,838 and subsequently accounted for as follows:

Year	Carrying amount at beginning of period £	Interest at 5% £	Cash outflow £	Carrying amount at end of period £
20X1	863,838	43,192	0	907,030
20X2	907,030	45,451	0	952,381
20X3	952,381	47,619	(1,000,000)	-

Assuming that the loan is made by the director in his or her capacity as the owner of the business, the difference of £136,162 (£1,000,000 - £863,838) should be recognised directly in equity as a capital contribution.

The double entry required is as follows:

Dr Cash at bank	£1,000,000	
Cr Loan payable		£863,838
Cr Capital contribution – equity[4]		£136,162
Being initial recognition of loan		
Dr Profit or loss – interest expense[4]	£43,192	
Cr Loan payable		£43,192
Being application of amortised cost method in 20X1, with similar entries in 20X2 to 20X3		
Dr Loan payable	£1,000,000	
Cr Cash at bank		£1,000,000
Being repayment of loan		

[4] As explained in Tech 02/17BL 9.48 and 9.50-9.51 in the context of a loan from parent to subsidiary, the credit to equity for the capital contribution and the interest expense are not considered to be realised profits or losses. This capital contribution could be taken to either retained profits or another separate component of equity. When it is taken to a separate component of equity, entities may wish to make an annual transfer from this reserve to the P&L reserve of an amount equal to the interest expense recognised under the amortised cost method. However, this transfer is not required by FRS 102.

EXAMPLE 2 – LOAN FROM COMPANY TO DIRECTOR

The situation is as above, except that the company is lending the money to the director.

Assuming that the loan is made to the director in his or her capacity as the owner of the business, the difference should be recognised directly in equity as a distribution.

The double entry required is as follows:

Dr Loan receivable	£863,838	
Dr Distribution – equity[5]	£136,162	
Cr Cash at bank		£1,000,000
Being initial recognition of loan		
Dr Loan receivable	£43,192	
Cr Profit or loss – interest income[6]		£43,192
Being application of amortised cost method in 20X1, with similar entries in 20X2 to 20X3		
Dr Cash at bank	£1,000,000	
Cr Loan receivable		£1,000,000
Being repayment of loan		

[5] Tech 02/17BL 2.6A states that a transaction at an undervalue is capable of being a distribution if it involves in substance an element of gift to the transferee. Companies considering entering into such transactions may wish to seek legal advice.

[6] The interest income will be considered realised if the loan receivable meets all the criteria for qualifying consideration ie there is reasonable certainty that the balance can be repaid at maturity and an expectation that it will be settled without a replacement loan being advanced (Tech 02/17BL 9.59).

EXAMPLE 3 – SEASON TICKET LOAN

On 1 January 20X1, a company provides a director with a £1,200 interest free season ticket loan. The loan – which is repayable at £100 per month over the course of the next year – is on terms available to other members of staff.

The market rate of interest for a similar loan is 6% per annum or 0.5% per month[7].

Under pre-FRS 102 UK GAAP, the company would simply record the loan at £1,200 and no interest would be recognised. However, under FRS 102 the amortised cost method must be applied, with the loan initially recognised at the present value of future payments discounted using the effective monthly interest rate. This can be calculated to be £1,161.89 ie, the present value of £100 a month for each of the next twelve months discounted using the effective interest rate of 0.5% per month.

As the loan is not made to the director in his or her capacity as the owner of the business, the difference of £38.11 (£1,200.00 - £1,161.89) should be expensed over the life of the loan. Interest on the loan will then be recognised over its life as follows:

Month	Carrying amount at beginning of month £	Interest accrued at 0.5% £	Cash payment £	Carrying amount at end of month £
Jan	1,161.89	5.80	(100.00)	1,067.69
Feb	1,067.69	5.34	(100.00)	973.03
Mar	973.03	4.87	(100.00)	877.90
Apr	877.90	4.39	(100.00)	782.29
May	782.29	3.91	(100.00)	686.20
Jun	686.20	3.43	(100.00)	589.63
Jul	589.63	2.95	(100.00)	492.58
Aug	492.58	2.46	(100.00)	395.04
Sep	395.04	1.98	(100.00)	297.02
Oct	297.02	1.49	(100.00)	198.51
Nov	198.51	0.99	(100.00)	99.50
Dec	99.50	0.50	(100.00)	-

[7] The monthly rate of 0.5% is calculated simply by dividing the annual rate of 6% by 12. This is based on the assumption that interest compounds monthly.

The cumulative double entry over the life of the loan is therefore as follows:

Dr Loan receivable	£1,161.89	
Dr Expense – employee benefits	£38.11	
Cr Cash at bank		£1,200.00
Being initial recognition of loan		
Dr Loan receivable	£38.11	
Cr Profit or loss – interest income		£38.11
Being application of amortised cost method		
Dr Cash at bank	£1,200.00	
Cr Loan receivable		£1,200.00
Being repayment of loan		

Although the aggregate effect of all such loans should be considered, the amount of the discount on this and similar season ticket loans may be considered immaterial. If this is the case, the loans could simply be carried at cost.

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