Interest from Inter-Company Loans

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Introduction

"B" a recognized conglomerate in Sri Lanka is composed of companies successfully operating in several industry sectors managing businesses in varied markets. Expanding overseas into the international market, B has spread its products and services globally. The group continues to grow through innovative technology, introducing new products that successfully carve themselves a place in the world of consumer demand.

B Company spread their business under several sector. Such as manufacturing, healthcare, Leisure and transportation. Their main target is to provide superior most innovative products to their local as well as foreign customers.

Subsidiaries are those enterprises controlled by the Company. Control exists when the Company has the power, directly or indirectly to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

The details of Subsidiaries are as follows:

Company Name	Ownership percentage
B1 Company	100%
B2 Company	100%

B Company provides financial facilities for their subsidiaries. They include that balance under current asset as a receivable balance from related parties.

Discussion of Issue

B Company provides financial facility for their subsidiaries for a short period of time. There is an agreement between parent company and subsidiaries to lend money for their subsidiaries. If parent company provides the financial facility for their subsidiaries they should have to settle that amount before one month. If they fail to settle that amount, parent company does not provide any financial facility for subsidiaries until settled the provided facility.

But B Company does not charge any interest for that provided loan. As for the reason they said that they provide that facility to their subsidiaries for a short period. But the provided amounts are adequate and when they charge interest for that facility, that interest amount is material.

We asked written approval for not charging interest from their subsidiaries. But they did not provide any written approval for our inspection. Therefore, according to our professional judgment we decided B Company should have to recognize this interest in their financial statements.

Implication of the Issue

According to the financial reporting framework, income is recognized in the income statement when increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

Due to this provided short term loans for their subsidiaries, increase the company asset. Therefore, company should have to recognize this interest as an income in their financial statements. Because, B Company is one company include in the group and as a single company they have to recognize this interest as an income under their comprehensive income statement. As a whole group, they can eliminate this inter group transaction when they preparing their consolidated financial statements.

According to the LKAS 39 company recognized this provided loan as loan and receivables under financial asset. They initially recognize this financial asset at Fair Value and any transaction cost are directly charge to the Profit and Loss account. There is no any subsequent recognition because this loan they provided for a short period of time.

We calculated one month interest of that facility as follows by using market interest rate of other companies in the market used to charge interest for similar type of loans to show how that interest amount is material.

Company	**Amount provided**	**Interest rate**	**Number of Days**	**Interest amount**
B1 Company	15Mn	7.5%	25	=(15Mn*7.5%)/365*25 = **77,055**
B2 Company	20Mn	7.5%	28	=(20Mn*7.5%)/365*28 = **115,069**

There is a tax effect also, because if they recognized this interest income in their accounts they should have to pay tax for that interest. Therefore, company tax expense increase. We can calculate that increased tax amount as follows.
Increase of tax expense = (77,055 + 115,069) * 28%
= **53,795**

Conclusion and Recommendation

We recommended the management of the B Company to recognize this interest income as other income in their financial statement. Because, there is no any board approval for not charge interest from their subsidiaries. Therefore according to the financial reporting framework B should have to recognize this interest income in their accounts. As well as they have to recognize the tax effect in their accounts.