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Confusion in accounting for intra-group loan transaction between parent and its wholly owned subsidiary

By

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Abstract

Companies within the group are often separate legal personalities and therefore able to freely transact with each other provided there is no intent to defraud the general public through financial statement fraud schemes. The group accounts produced thereof are required to eliminate all intra-group transactions in line with IFRS 3 – Business Combination and Companies Act in view of the IFRSs being embedded in the company laws. This study evaluated the parent-subsidiary loan transaction in which the parent advanced a loan to its wholly owned subsidiary specifically established to provide intra-group services. The loan was attracting interest and later both the principal and interest were converted into equity. The conclusion of this study is that interest on the intra-group was not supposed to be charged in the first place and should be reversed since the group cannot benefit from itself and furthermore, the loan should not have been there in the first place if parent had adequately funded its subsidiary.

Type of Paper: Transaction Analysis

Key words: Intra-group; Eliminate; Transaction; Malawi

1.0 Introduction

One of the tenets of the consolidation procedures is that intra-group transactions (such as sales and purchases or loans or rentals etc between parent and subsidiaries) are eliminated if not passed on to third parties, before group accounts can be produced. This is because the group cannot make profit out of itself. Furthermore, intra-group accounts if not eliminated would promote creative accounting and distort the quality of the consolidated financial statements with significant ramifications on the users of the financial statements – Kampanje (2013). There could be possibility of error when intra-group transactions are wrongly processed but to a greater extent would be as a result of financial statement fraud committed through intentional misstatements including omissions and disclosures to deceive users of financial statements – Kampanje (2017).

It is also true to note that parent and subsidiary are two different legal personalities if they are both incorporated under companies act such that commercial dealings between the two entities are entirely legitimate provided appropriate disclosures are made in the financial statements to assist users of financial statements evaluate how much the reporting entity is benefitting from its related parties as noted in Kampanje (2012).

1.1 Background to the study

This study stems out of the disclosure in the notes of the annual report for 2020 for one of the listed companies on the Malawi Stock Exchange whose content is as follows:

[XYZ granted a three year interest free loan to its subsidiary, KLM Limited. The difference between the nominal loan amount and the present value of the loan discounted using the market interest rate is accounted for as an investment in subsidiary. Correspondingly, in the subsidiary's individual financial statements this is accounted for in equity as a capital contribution.].

1.2 Research objectives

a) Assess the level of disclosure regarding the treatment of the intra-group loan in the consolidated financial statements.
b) Investigate the completeness of the intra-group loan transactions.
c) Evaluate whether arm's length conditions were adopted in the intra-group loan transactions.

2.0 Analysis of the loan transaction

2.1 Loan maturity date

There was no disclosure of such information despite the tenor of the loan being three years. The actual maturity date of the loan is always important for the calculation interest expense/income.

2.2 Loan pricing

There were no disclosures regarding the applicable interest rate on the loan and any other facility fees such as draw down fees, documentation fees etc. This was a missed opportunity as stakeholders would have a chance to check whether the transaction was concluded at arm's length transaction (not too low to simply benefit the subsidiary and not too high to inflate the income the holding company).

Interest income recognised by the parent company was erratic.

It was not earned in some years and fluctuated significantly making it difficult to analyse the trend. The absence of critical information was not helpful to the stakeholders.

2.3 Evidence of the loan disbursements

The 2018 annual reports indicated that the subsidiary had a loan balance of about of US$1.200 million as shown in the related party transactions note. This loan was not reflected in the statement of cash flows of the parent company casting doubt of its authenticity. The loan disbursement was however reflected in the parent's statement of cash flows in the following year and the amount was about 2.25 times the value of the original loan. There were no explanatory notes regarding the whereabouts of the original loan vis-à-vis whether it was paid or not or whether only the difference between the amount reflected in the statement of cash flows and the figure previously reflected in the related party transactions note. There was also an interest charge reflected in the related party transactions note of about US$0.300 million but it was not reflected in the statement of profit or loss of the parent. The loan receivable balance was however much higher than the total of loan disbursement shown in the statement of cash flows and the interest charge of US$0.300 million.

2.4 Interest on the intra-group loans in 2020 and 2021

As earlier indicated, there was no disclosure of the applicable interest rate on the intra-group loan and interest earned by parent company was US$0.420 million and US$0.250 million in 2020 and 2021 respectively. The note for such transaction was "interest on other assets" in the note for interest income but was included in the related party transaction section without mentioning the name of the counterparty. Failure to disclose the interest earned from related party makes it difficult to evaluate whether it has been eliminated in the group accounts.

2.5 Conversion of intra-group loan into equity of investee

It was disclosed in the 2021 annual reports that the total loan payable by the wholly owned subsidiary was converted into the equity. The converted loan comprised of both principal (whose exact amount could not be determined in the records publicly available) and interest earned on that principal sum (again whose interest rate was not publicly disclosed).

It was not disclosed in the group accounts regarding the amount of the stated capital of the wholly subsidiary but the initial paid capital was meagre and nominal in nature which is no longer the practice of the corporate law across the global as it is now prohibited to issue shares of par value such that creation of share premium account is no longer acceptable – Kampanje (2021). The wholly owned subsidiary was incorporated to exclusively serve the group and therefore majority and if not all its revenue generated would be through intra-group (related party) transactions. It was therefore surprising that it was granted a loan which was accumulating interest which was about US$1.000 million and the same was part of the loan converted into equity of the subsidiary. The total equity of the subsidiary was probably overstated as that was not the value of the funds it received and more importantly, the wholly owned subsidiary was required to purchase assets to provide services to the entire group and it was the responsibility of the parent to adequately fund it. Charging of interest on a loan to a wholly owned subsidiary established exclusively to support the group violated the principle of substance over legal form as noted by Kampanje (2018). This is because the group could not make profit out of itself as this violated the principles of IFRS 3 – Business Combination.

3.0 Conclusion and recommendations

There is undoubted breach of financial accounting principles and corporate law in the treatment of the intra-group loans in the consolidated financial statements. The said transactions spread over a period of about four years and therefore the group external auditors were supposed to pick up the matter as area of concern but nothing happened until the loan was converted into inflated equity. The effectiveness of external auditors has always been questioned as observed by Kampanje (2012).

It is recommended that interest earned on the intra-group loan from parent to its wholly owned subsidiary which was later converted into equity should be reversed in its entirety so that interest is eliminated to preserve the tenets of IFRS 3 – Business Combination so that all intra-group transactions are eliminated.

It is high time external auditors must prove that they are up to the job they willingly seek to do because financial accounting exceptions noted herein should have been picked up by external auditors through use of professional judgement to assist users of the financial statements make well informed decisions. The current scenario puts significant risks on the users of the financial statements who must adopt the “caveat emptor approach”. This is not good for the Malawi Stock Exchange.

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