Measurement and Recognition of Government Loans at a Below Market Rate of Interest

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Introduction

Public and private hospitals are funded from a range of different sources, reflecting the types of patients they treat and the services they provide.
ABC is a Private hospital has been established itself as the one of the best hospitals in Sri Lanka with a mission to provide wide-range of healthcare facilities to all sections of the society in Sri Lanka.

Discussion of the Issue

On 01st April 2014, ABC hospital revived a government loan Rs.90, 000 @ 5% interest rate. The prevailing market interest rate was 10%. The loan is repayable within four years. It requires four equal total payments of accrued interest and principal on March 31 of each year from 2015 to 2018.

This loan will be utilized for the purchase of a machine which will be used for medical treatments. The total cost of the machine was Rs.200, 000 with an estimated life of four years. The company depreciated its machinery using the straight-line method.

At the time of initial recognition, The Company had recognized loan amount as cash received to them. Therefore, the company passed the journal entries as follows:

Cash Dr. Rs.90, 000
Loan Cr. Rs.90, 000
(Initial recognition of the loan as at 01 .04.2014)

Period ending date	Beginning balance Rs.	interest expense (Interest rate @ 5%) Rs.	Capital portion payable Rs.	cash flows Rs.	Ending balance Rs.
2015	90,000	4,500	20,881	25,381	69,119
2016	69,119	3,456	21,925	25,381	47,194
2017	47,194	2,360	23,021	25,381	24,173
2018	24,173	1,208	24,173	25,381	0
		11,524	90,000	101,524	

Based on above company's amortization schedule, at the time of Subsequent recognition, the journal entry was passed as follows.

Loan Dr. 20,881

Interest expense Dr.4, 500

Cash Cr.25, 381

(Subsequent recognition: Being recoding the loan repayment as at 31.03.2015)

The loan had not been recognized and measured in accordance with LKAS 39 Financial Instruments: Recognition and Measurement and also the company had not recognized the benefit received on the difference between the market rate and the interest rates charged on the government loan as per LKAS 20.

Implication of the Issue

Since the company's materiality level is too low, this issue had significant effect on Comprehensive income statement, statement of financial position and disclosures as well as this is a kind of government assistance for Company's financial difficulties. The company had overstated the Loan liability and ignored the benefits received from the below market rate of interest from the Government.

Conclusion and Recommendations

As per LKAS 20, the benefit of the interest below the market rate should be measured as the difference between the initial carrying value of the loan determined in accordance with LKAS 39 and the proceeds received.

Grant = cash received less the present value of the loan

Present value of the loan must be calculated by discounting the four years cash flows (25,381 per year), at prevailing market rate 10%. Amount is equal to Rs.80, 454. Therefore as per LKAS 20,

Government Grant = Rs.90, 000 –Rs.80, 454 = Rs. 9,546

Then, Initial journal entry should be as at 01.04.2014 as follows.

Cash Dr.90, 000

Loan Cr.80, 454

Grant Cr.9, 546 (PPE or Deferred income)

(Initial recognition of the Loan balance as at 01.04.2014)

The grant amount (Credited) Rs, 9,546 can be recorded either as a grant related to asset or a grant related to income in accordance with LKAS 20. In this situation, as the grant was received for the acquisition of a Machinery (PPE) or asset, In this case, there are two options to present the grant in the financial statements:

- To present it as deferred income; or

- To deduct the grant from the carrying amount of an asset acquired.

By applying the market interest rate 10%, following amortization schedule must be developed as per LKAS 39;

Period ending date	Beginning Loan balance Rs.	interest expense (Market Interest rate @ 10%) Rs.	Capital portion payable Rs.	cash flows Rs.	Ending balance Rs.	Present value @10% market rate Rs.
2015	80,454	8,045	17,336	25,381	63,118	23,074
2016	63,118	6,312	19,069	25,381	44,049	20,976
2017	44,049	4,405	20,976	25,381	23,073	19,069
2018	23,073	2,307	23,073	25,381	0	17,335
		21,069	80,454	101,524		80,454

Based on correct amortization schedule, the subsequent Journal entries for the period 2014/15 should be as follows.

Interest expense Dr.8, 045
Loan payable Cr 8,045
(Being adjusting the interest expense for the period of 2014/15)

Loan payable Dr. 25,381
Cash Cr. 25,381
(Being adjusting the cash settlement of loan 2014/15)

The subsequent recognition of grant value should be recognized according to selected approach based on LKAS 20.

<u>Option 1: Deferred Income</u>

Then, the subsequent journal entries are:

Description	Amount Rs.	Debit	Credit
Recognition in P/L in 2015	(9,546/4) = 2,387	SOFP – Deferred income	P/L – Income from government grant

Note: SOFP = Statement of Financial Position

Option 2: Deduction from an asset

Then. The subsequent journal entries are:

Description	Amount Rs.	Debit	Credit
Recognition in P/L in 2015 (within depreciation charge)	(190,454/4)= 47,614	P/L – Depreciation (machine)	SoFP – PPE (machine)

Note: SOFP = Statement of Financial Position

However, there are some practical implications, the existing standards might be lacking to address. Therefore, needed to be concerned and recommended to account on following aspects in future.

- ❖ Mainly, LKAS 39 focuses on the market rate rather than the cost of capital, governments would have to adopt a technique or appropriate mechanism based on a hypothetical market rate. So this has produced questionable results as participants' perception.
- ❖ The nature of loans issued by governments are typically not equivalent to those issued in private markets. Principally, this is because the government usually wants to achieve a policy objective that cannot be done through existing market mechanisms.
- ❖ In another way, the relevance of information on how much interest would have been charged on a below-market rate government loan if it were granted on an arm's length commercial basis.