# IFRS hot topics

## Intercompany loans

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# 1 Scope of intercompany loans

# Intercompany loans

*Scope of intercompany loans*

***Still applicable***

IAS 32.16

*A financial instrument* ***is an equity instrument*** *rather than a financial liability if, and only if:*

*(a) the instrument includes* ***no contractual obligation****:*

*(i)* ***to deliver cash or another financial asset*** *to another entity; or*

*(ii) to exchange financial instruments under unfavourable conditions.*

*(b) if it will be settled in the issuer's own equity instruments:*

*(i) a non-derivative* ***without a contractual obligation to deliver a variable number of*** *shares; or*

*(ii) a derivative that will be settled by exchanging a fixed amount of cash or another financial asset for a fixed number shares.*

Subsidiary A has the unconditional right to avoid settlement of the loan in cash, another financial asset, or in a variable number of equity instruments

Yes → Equity

No → Financial liability

# Intercompany loans

*Scope of intercompany loans - Practical considerations*

**Need to understand the terms of the loan - agreement is important**

**What if terms are not clear?**

- What does the documentation/contract say?
- Does it allow for any discretion?
- If silent - assumption is structured as a loan unless evidence proving otherwise “contractual evidence”
- Changes to contracts are always prospective - consultation if considering otherwise



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# 2 Measurement of intercompany loans

# *Loans on commercial terms*

# Intercompany loans

*Intercompany loans provided on commercial terms*

Situation is unlikely with related parties [IFRS 13. Appendix A definition market participant

- Parent A provides funding to Subsidiary A
- Loan terms - Fixed terms of repayment and market related interest
- Subsidiary A classifies the loan as a financial liability. Based on the scope guidance - Parent A will account for the loan as a financial asset in the scope of IFRS 9.

| | **Subsidiary** | **Parent** |
|---|---|---|
| **Initial recognition** | *Financial liability measured at fair value = cash received* | *Financial asset measured at fair value = cash received* |
| **Subsequent measurement** | *Amortised cost* | *Amortised cost (assuming cash flows are solely payments of principal and interest)* |
| **Classification** | *Depends on terms:*<br>*> 12 months is non-current*<br>*< 12 months is current* | *Depends on terms:*<br>*> 12 months is non-current*<br>*< 12 months is current* |

# *Loans at non-commercial terms with fixed term*

# Intercompany loans

*Loans at non-commercial terms with fixed terms*

- Parent A provides a loan of $100 million to Subsidiary A
- Loan terms - Interest free loan with fixed terms of repayment
- Subsidiary A classifies the loan as a financial liability. Based on the scope guidance - Parent A will account for the loan as a financial asset in the scope of IFRS 9.
- At what amount should both Parent A and Subsidiary A account for the loan at initial recognition?

Fair value - market interest rate

Face value of $100 million

*Answer: Fair value using a market interest rate*

- *The financial liability/asset will be recorded at fair value and subsequently measured at amortised cost*
- *Contractual terms - interest free - fair value has to be determined using a market related interest rate for a similar instrument*

# Intercompany loans

*Loans at non-commercial terms with a fixed term*

- The recognition of the loan at fair value results in a difference between the cash advanced of $100 million and the fair value of the financial liability.
- How should the Day 1 difference be accounted for by Subsidiary A?

Profit or Loss

Equity

It depends

*Answer: It depends*

- *Accounted for based on substance of transaction*
- *Most instances - equity contribution - difference attributed to parent acting in capacity as parent/shareholder.*
- *Substance could be off-market financial instrument - then P/L - expected to be rare up-front loss is recognised if it all inputs are level 1 observable (IFRS 9 para B5.1.1, B5.1.2A)*

# Intercompany loans

*Loans at non-commercial terms with fixed terms*

- The recognition of the loan at fair value results in a difference between the cash advanced of $100 million and the fair value of the financial asset.
- How should the Day 1 difference be accounted for by Parent A?

Profit or Loss

Investment in subsidiary

It depends

*Answer: It depends*

- *Understand the substance of the transaction to determine if it is an addition to equity or a day one gain in P/L.*
- *The substance is generally a capital contribution with the parent acting in its capacity as a shareholder.*
- *In rare circumstances, the substance is the issue of off-market financial instrument then an up-front loss is recognised if it all inputs are level 1 observable (IFRS 9 para B5.1.1, B5.1.2A)*

# Intercompany loans

*Loans at non-commercial terms – unwind of day 1 difference*

- The recognition of the loan at fair value results in a difference between the cash advanced of $100 million and the fair value of the financial asset.
- How should the unwind of the day 1 difference be accounted for by Parent A and the subsidiary subsequently?

It depends

In equity

In the income statement

*Answer: In the income statement*

- *Assuming that the parent/subsidiary does not elect to carry the loan as at fair value through profit or loss, the financial asset/liability is subsequently measured at amortised cost, with interest accrued using the effective interest rate method.*
- *The unwind of difference is recorded in the income statement using the effective interest method as interest income*

# Intercompany loans

*Loans at non-commercial terms with fixed terms*

- Parent A provides funding to Subsidiary A
- Loan terms - Interest free loan with fixed terms of repayment

| | **Subsidiary** | **Parent** |
|---|---|---|
| **Initial recognition** | *Financial liability measured at fair value - not equal to the cash advanced*<br>*Day 1 difference - should be accounted for based on substance generally equity and rarely in P/L* | *Financial asset measured at fair value - not equal to the cash advanced*<br>*Day 1 difference - should be accounted for based on substance generally investment in sub and rarely in P/L* |
| **Subsequent measurement** | *Amortised cost* | *Amortised cost (assuming cash flows are solely payments of principal and interest)* |
| **Classification** | *Depends on terms:*<br>*> 12 months is non-current*<br>*< 12 months is current* | *Depends on terms:*<br>*> 12 months is non-current*<br>*< 12 months is current* |

# *Loans repayable on demand with no interest*

# Intercompany loans

*Loans repayable on demand with no interest*

- Parent A provides a loan of $100 million to Subsidiary A which is contractually repayable on demand and bears no interest.
- Parent A may recall the loan in future, but its intention as communicated to Subsidiary A is that the loan will only be recalled when the subsidiary has surplus cash and the parent requires the cash for other purposes.
- The parent does not see such an event occurring in foreseeable future.
- How should Parent A account for the loan given to Subsidiary A?

Financial asset - IFRS 9

Investment in subsidiary

*Answer: Financial asset in IFRS 9*

- *Major change expected - currently similar loans accounted for as part of investment in subsidiary*
- *Scoping guidance - IFRS 9 makes it clear that accounting is based on subsidiary classification*
- *Financial liability for subsidiary = Financial asset for parent*

# Intercompany loans

*Loans repayable on demand with no interest*

- Parent Co provides a loan of $100 million to Subsidiary Co which is contractually repayable on demand and bears no interest.
- Parent Co may recall the loan in future, but its intention as communicated to Subsidiary Co is that the loan will only be recalled when the subsidiary has surplus cash and the parent requires the cash for other purposes.
- The parent does not see such an event occurring in foreseeable future.
- At what amount should Subsidiary A record the loan at initial recognition?

Face value of $100 million

Fair value - market interest rate

*Answer: Face value of $100 million*

- *Since there is no minimum term and the parent can demand payment at any time. The loan is recorded at face value. (IFRS 13, paragraph 47)*

# Intercompany loans

*Loans repayable on demand with no interest*

- Parent Co provides a loan of $100 million to Subsidiary Co which is contractually repayable on demand and bears no interest.
- Parent Co may recall the loan in future, but its intention as communicated to Subsidiary Co is that the loan will only be recalled when the subsidiary has surplus cash and the parent requires the cash for other purposes.
- The parent does not see such an event occurring in foreseeable future.
- At what amount should Parent A record the loan at initial recognition?

Fair value - market interest rate

Face value of $100 million

*Answer: Face value of $100 million*

- *Since there is no minimum term and the parent can demand payment at any time. The loan is recorded at face value. (IFRS 13, paragraph 47)*
- *Major change from IAS 39 which was based on when cash was expected to be recovered.*

# Intercompany loans

*Loans repayable on demand with no interest*

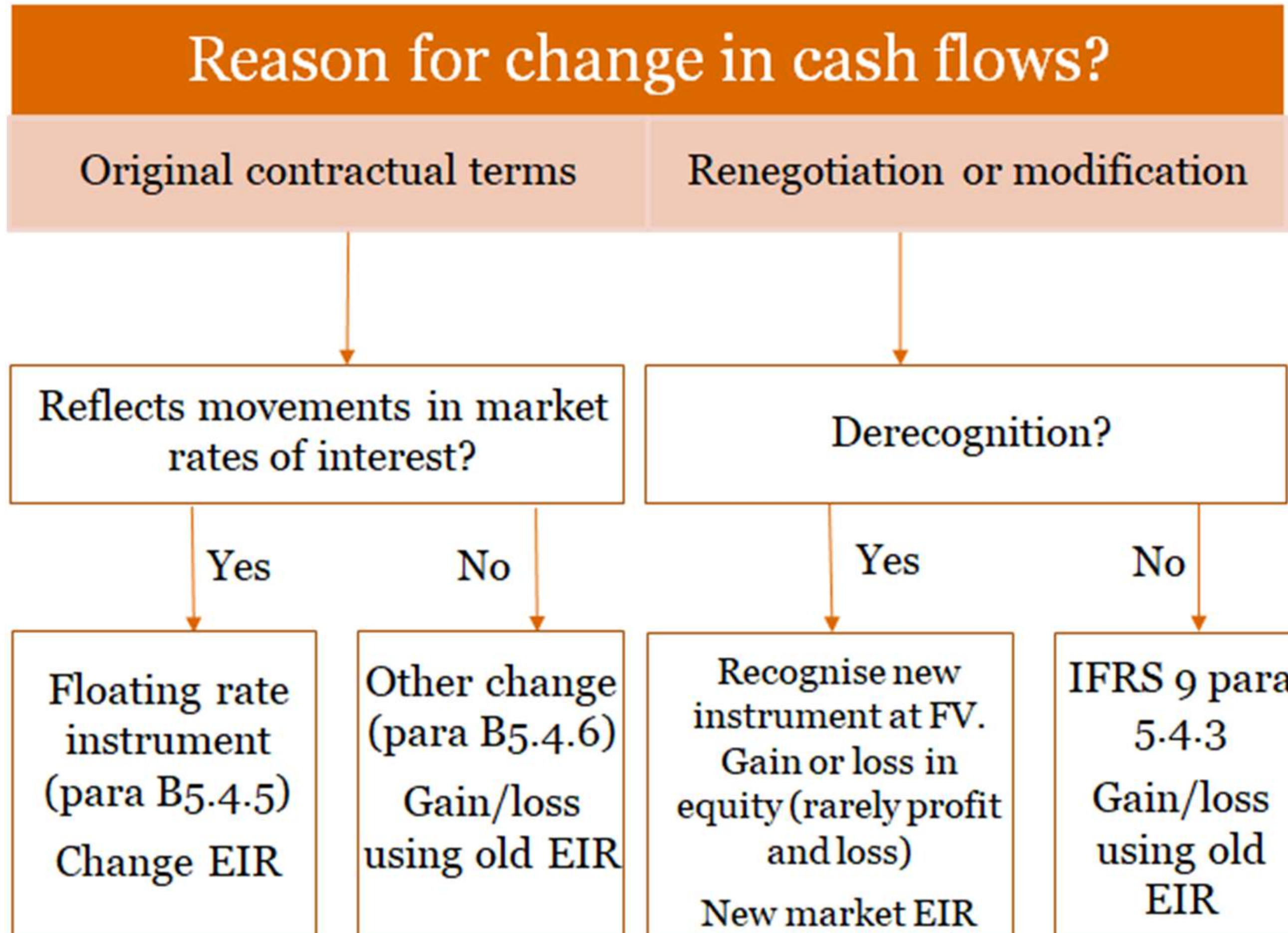
- Parent A provides funding to Subsidiary A
- Loans repayable on demand with no interest

| | **Subsidiary** | **Parent** |
|---|---|---|
| **Initial recognition** | *Financial liability measured at fair value - equal to face value [IFRS 13.47]* | *Financial asset measured at fair value - face value* |
| **Subsequent measurement** | *Amortised cost* | *Amortised cost (assuming cash flows are solely payments of principal and interest)* |
| **Classification** | *< 12 months is current* | *Depends on when cash flows are expected to be realised:*<br>*> 12 months is non-current*<br>*< 12 months is current*<br>***NB: Difference between asset and liability*** |

# *Modification/extinguishment of intercompany loans*

# Intercompany loans

*Modification / Extinguishment of intercompany loans*



# Intercompany loans

*Modification of intercompany*

- Parent A provides funding to Subsidiary A
- Parent A modifies the loan terms which do not result in extinguishment

| | Subsidiary | Parent |
|---|---|---|
| **Initial recognition** | *Not applicable - instrument has been recognised* | *Not applicable - instrument has been recognised* |
| **Impact of modification** | *Recalculate the carrying amount of the financial liability using the original EIR*<br><br>*Adjust the carrying amount to reflect the new carrying amount*<br><br>*Difference - consider substance in most cases in equity and rarely income statement* | *Recalculate the carrying amount of the financial asset using the original EIR*<br><br>*Adjust the carrying amount to reflect the new carrying amount*<br><br>*Difference - consider substance in most cases against investment in sub and rarely income statement* |

# Intercompany loans

*Extinguishment of intercompany loans*

- Parent A provides funding to Subsidiary A
- Parent A modifies the loan terms which  result in extinguishment

| | **Subsidiary** | **Parent** |
|---|---|---|
| **Initial recognition** | *Refer example above for new loans* | *For example above new loans* |
| **Impact of extinguishment** | *Recalculate the carrying amount of the financial liability using the new EIR*<br><br>*Adjust the carrying amount to reflect the new carrying amount*<br><br>*Difference - consider substance in most cases in equity and rarely income statement* | *Recalculate the carrying amount of the financial asset using the new EIR*<br><br>*Adjust the carrying amount to reflect the new carrying amount*<br><br>*Difference - consider substance in most cases against investment in sub and rarely income statement* |

# Intercompany loans

*Loans repayable on demand with no interest – letter of support*

- Parent Co provides a loan of $100 million to Subsidiary Co which is contractually repayable on demand and bears no interest.
- The parent has provided the Subsidiary a letter of support prior to the balance sheet date indicating that payment will not be required for a period of at least 12 months from the balance sheet date
- What impact does the letter of support have on the measurement of the loan by the parent?

Consider terms of the letter of support in the accounting

It depends

*Answer: It depends*

- *Depends on whether the letter of support is legally binding or simply an expression of intent.*
- *Where the letter is legally binding, the parent needs to determine whether the change in the terms of the loan represents a modification of the existing loan or the extinguishment of the original loan and the recognition of a new loan, in accordance with paragraph 3.2.3 of IFRS 9*

# Intercompany loans

*Loans repayable on demand with no interest – letter of support*

- Parent Co provides a loan of $100 million to Subsidiary Co which is contractually repayable on demand and bears no interest.
- The parent has provided the Subsidiary a letter of support prior to the balance sheet date indicating that payment will not be required for a period of at least 12 months from the balance sheet date
- What impact does the letter of support have on the measurement and current/non-current classification of the loan by the subsidiary in its financial statements?

Change classification from current to non-current

It depends

*Answer: It depends*

- *Depends on whether the letter of support is legally binding or simply an expression of intent.*
- *Where the letter is legally binding, the subsidiary needs to determine whether the change in the terms of the loan represents a modification of the existing loan or the extinguishment of the original loan and the recognition of a new loan, in accordance with paragraph 3.3.2 of IFRS 9 and change classification to non-current.*

# *Waiver of loans between group companies*

# Intercompany loans

*Waiver of loans between group companies*

- Parent A instructs subsidiary A to waive a receivable owed by Subsidiary B
- How should subsidiary A account for the waiver of loan given to Subsidiary B?

Derecognise loan in equity (transaction with shareholders)

Derecognise loan and release to profit and loss

*Answer: Derecognise loan in equity*

- *Clearly a transaction motivated by parent as this was done on their instruction*
- *Consider Conceptual Framework 2018 (6.81) refers to the substance of the transaction*
- *Substance is this is a transaction because of the common parent and is not on market terms - shareholder transaction*

# Intercompany loans

*Waiver of loans between group companies*

- Parent instructs subsidiary A to waive loan from subsidiary B

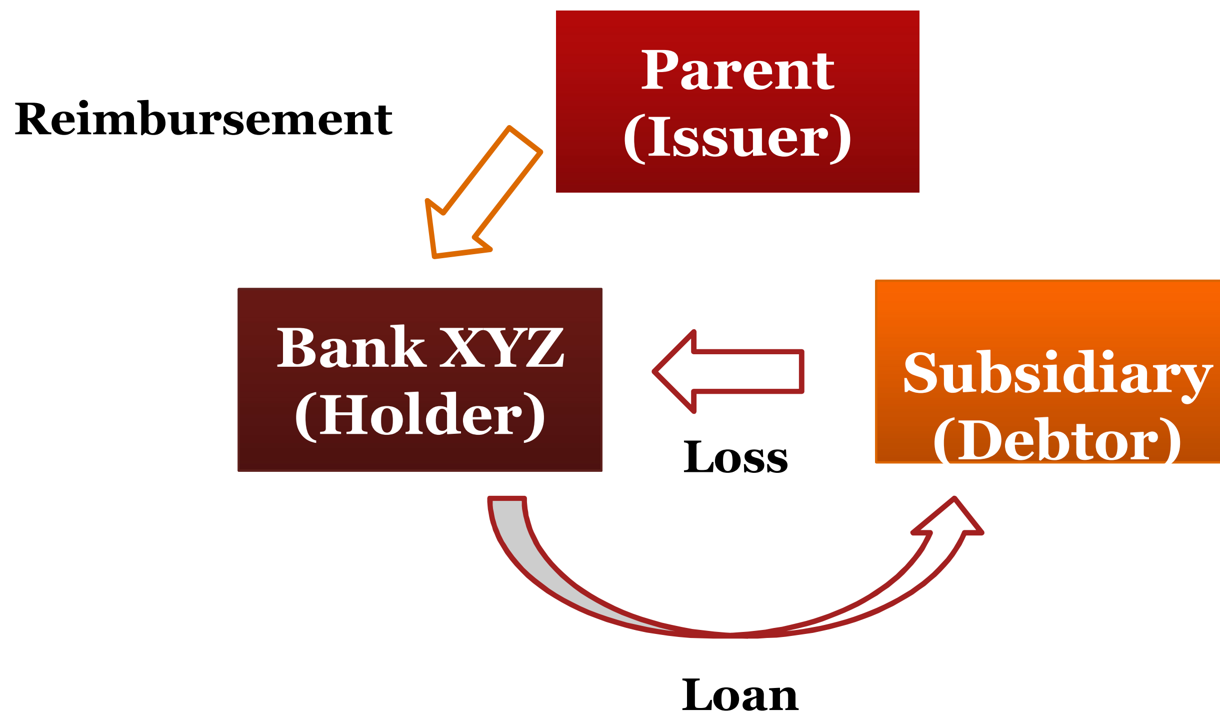
| | **Subsidiary** | **Parent** |
|---|---|---|
| **Derecognition** | *Derecognise loan receivable*<br>*Debit to equity with the equivalent amount (distribution to parent)* | *Derecognise loan payable*<br>*Credit to equity with the equivalent amount (contribution from parent)* |

# 3 Intercompany financial guarantees

# Intercompany financial guarantee contracts

*Definition*

A **contract** that requires the **issuer** to make specified **payments** to reimburse the **holder** for a **loss** that it incurs if a specified **debtor** fails to make payment when due under the terms of a **debt instrument's** original or modified terms.



# Intercompany financial guarantee contracts

*What is the issue?*

**Financial guarantees can go easily undetected**

**Establishing the fair value (Accounting in separates on day 1)**

- **References to market prices of similar instruments**
- **Interest rate differentials**
- **Discounted cash flow analysis (Expected value)**

**Financial guarantees subsequent measurement consideration**

# Intercompany financial guarantee contracts

*Has anything changed because of IFRS 9?*

- Parent A provided a financial guarantee to Parent B.
- Under IAS 39, financial guarantees were subsequently measured at higher of:
  - amount initially recognised (fair value, normally the premium received); and
  - amount determined in accordance with IAS 37.

**Does IFRS 9 change the subsequent measurement of a financial guarantee?**

**Yes**

**No**

**Yes, IFRS 9 scopes financial guarantees in for impairment requirements, even if no "financial asset" recognised**

- Financial guarantees subsequently measured at higher of
  - The amount determined in accordance with ECL model
  - Amount initially recognised (fair value) where appropriate, less the cumulative amortisation in terms of IFRS 15

# Intercompany financial guarantee contracts

*Example - ignore time value of money*

**Background:**

- A Subsidiary obtains a 10 year loan of CU1 000 000 from a Bank.
- The Parent entity, issues a financial guarantee to the Bank.
- Market related guarantees are issued at a fee of CU10 000
- No fee is paid by the subsidiary to the parent.

No accounting it is intercompany

Recognise financial guarantee at fair value

*Answer: Recognise financial guarantee at fair value*

# Intercompany financial guarantee contracts

*Example - ignore time value of money*

**Background:**

- A Subsidiary obtains a 10 year loan of CU1 000 000 from a Bank.
- The Parent entity, issues a financial guarantee to the Bank.
- Market related guarantees are issued at a fee of CU10 000.

**Assumptions after initial recognition:**

- Loss if there is a default: 90% of the exposure
- Probability this will happen: 5%

**Consider SICR and staging**

**Formula:** Exposure at default CU 1 000 000 x Loss % if default happens (90%) x Probability of default occurring (5%) = CU45,000

**Expected credit loss:** CU 45 000
VS
**Subsequent recognition:** of CU 9 000
[(CU 10 000/10) amortised over the loan period]

**Book CU45,000 as a liability under current liabilities**

# Intercompany loans

*Financial guarantees*

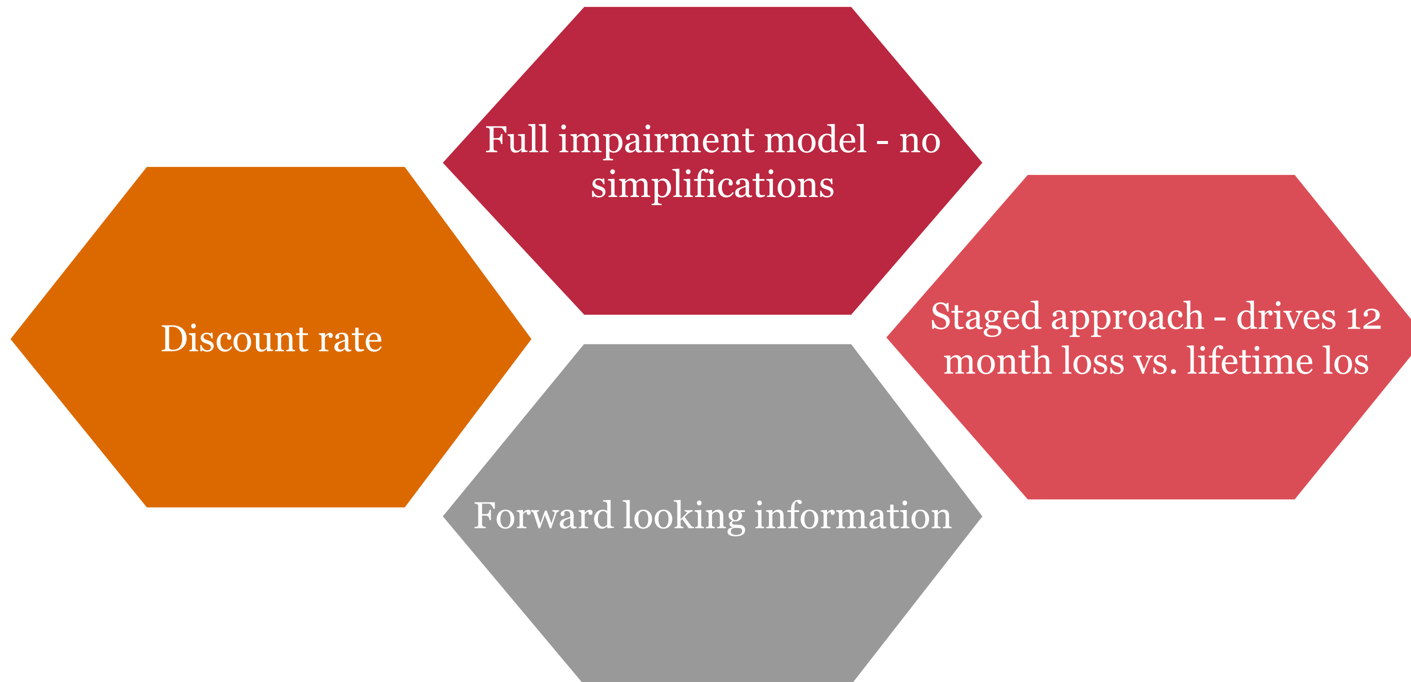
| | Subsidiary | Parent |
|---|---|---|
| **Initial recognition** | *No accounting* | *Dr Investment in subsidiary*<br>*Cr Financial guarantee premium* |
| **Subsequent recognition** | *No accoutning* | *Higher of:*<br>- *Financial guarantee premium*<br>- *ECL under IFRS 9* |

**Significant amount of disclosures in IFRS 7 and IAS 24**

# 4 Recap on impairment of intercompany loans

# Impairment considerations

*Intercompany loans*



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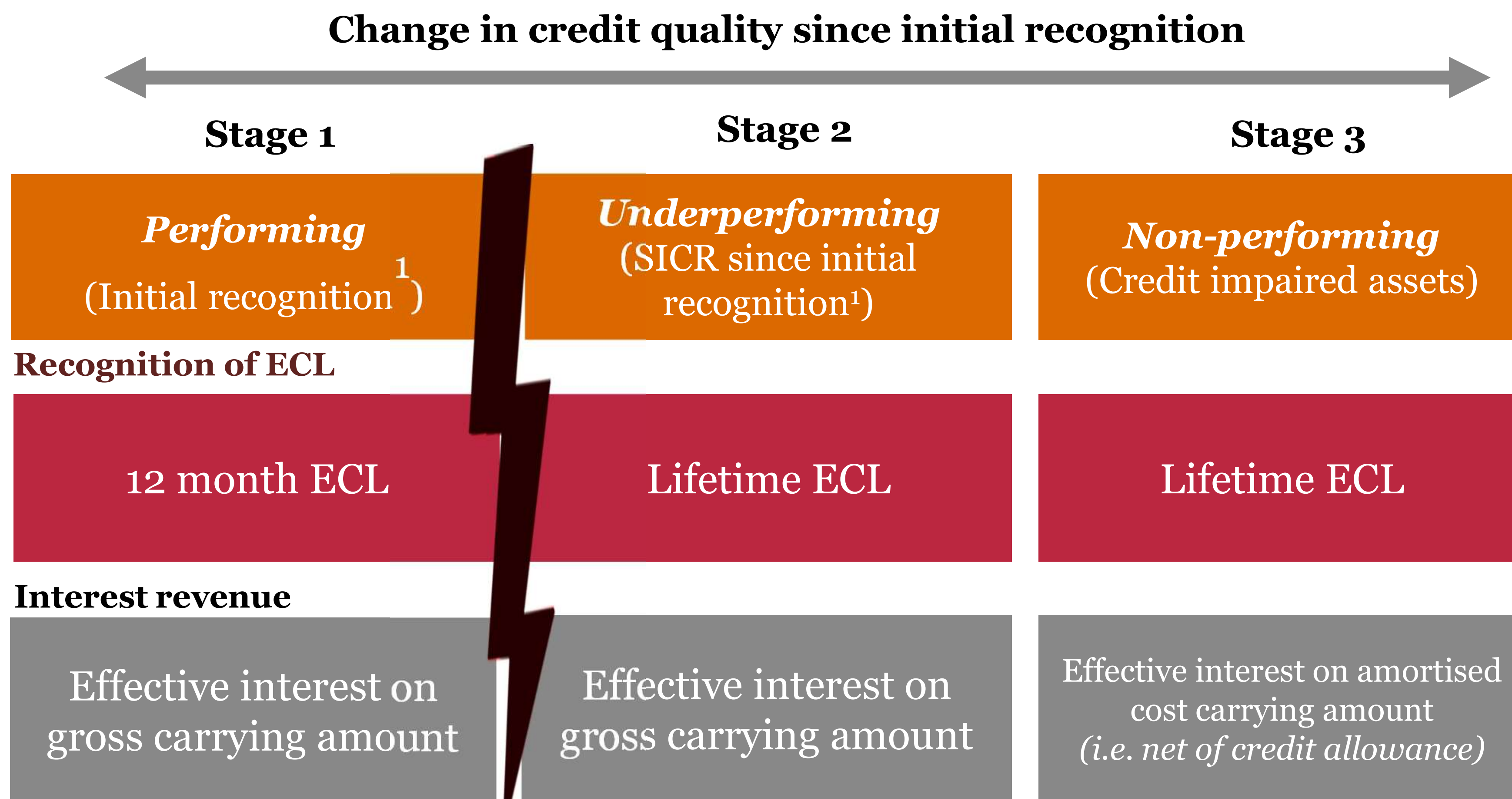
# *Impairment considerations*
## *Intercompany loans - General model*




*1. Except for purchased or originated credit impaired assets.*

# *Impairment considerations*

*Intercompany loans - expected credit loss*

Expected credit loss needs to be measured in a way that reflects:

**1**

***Unbiased & probability weighted amount***

- Range of possible outcomes

**2**

***Time value of money***

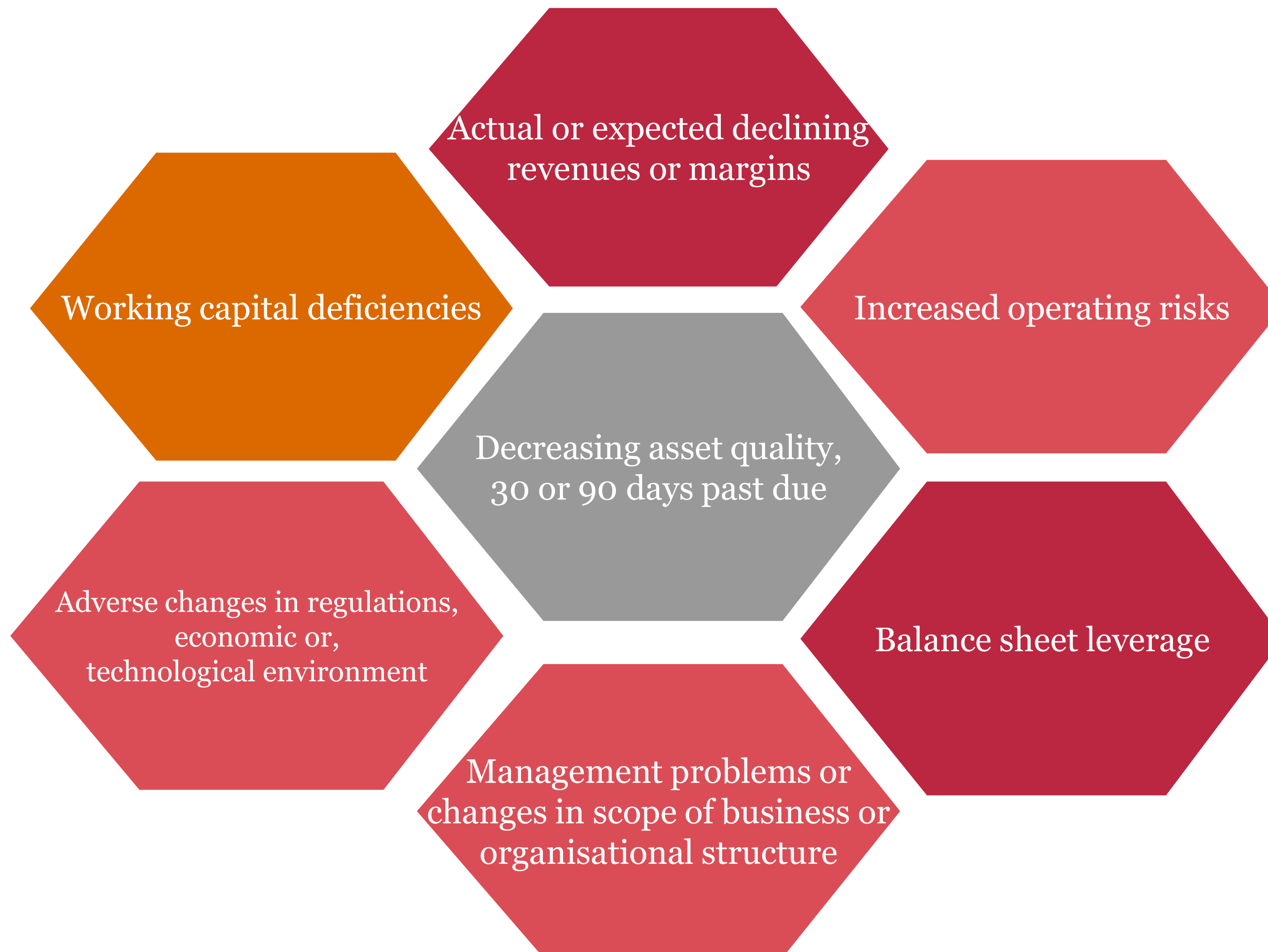
**3**

***Reasonable & supportable information that is available without undue cost or effort***

- Past events
- Current conditions &
- Forecasts of future economic conditions

# Impairment considerations

*Intercompany loans - Staging assessment*

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# Impairment considerations

*Intercompany loans - Terminology*

**ECL = PD x LGD x EAD**

ECL (‘Expected Credit Loss’) – that is, the future loss expected based on the probable future loss scenarios;

a) the PD (‘probability of default’) – that is, the likelihood that the borrower would not be able to repay;

b) the LGD (‘loss given default’) – that is, percentage that could be lost in the event of default; and

c) the EAD (‘exposure at default’) – that is, the outstanding balance of the loan.

# Impairment considerations

*Intercompany loans - Probability of default (PD)*

Starting point is internal information: internal credit rating, historical arrears, arrears on other loans, interest rates or credit spreads used for transfer pricing.

Need to take into account past events, current conditions and future economic conditions

Analyse macro-economic factors that could directly impact recoverability of loan - inflation, unemployment, interest rates, foreign exchange and impact has on PD.

Based on historic experience and understanding the industry/customer base of the borrower.

Need to take into account forward looking information.

External information: External credit rating information, external credit ratings agencies.

# Impairment considerations

*Intercompany loans - Incorporating forward looking*

Based on historic experience and understanding of the industry/customer base

General trends and changes in economy such as inflation, unemployment, interest or currency movements

Could also be geography or industry specific factors

Economic outlook reports

Modelled into PD or added as an overlay

# Impairment considerations
*Summary*

An impairment assessment has to be performed on intercompany loans - General model

Loans repayable on demand - one day contractual life - can subsidiary pay if loan is called in one day

Sufficient liquid assets and repay strategies need to be considered - impact of discounting must be taken into account

Forward looking information must be incorporated

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