RSM Insight: IFRS 9 – Intercompany Loan Receivables

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How IFRS 9 will impact intercompany loan receivables

Many intercompany loan receivables have no written terms, bear no (or a below market) interest rate; and/or do not have a fixed repayment date. Such features may pose real practical challenges when applying the classification and impairment provisions of IFRS 9 in separate/individual financial statements, as its application is premised on the existence of a contract.

This guidance note provides guidance on dealing with these two challenges for intercompany loan receivables in the scope of IFRS 9.

Note:
Whether an advance to a group member is in the scope of IFRS 9 should be determined, as under IAS 39, by reference to the IASB Conceptual Framework and considering the substance of the transaction. Where the advance is intended to be/or is akin to a capital contribution, or where the borrower has discretion not to repay under any circumstances, then an advance is likely to be considered a capital contribution and not in the scope of IFRS 9.

What is the impact of the rule changes on accounting for intercompany loan receivables?

Under IFRS 9, clients will need to assess whether an intercompany loan receivable can be classified and subsequently measured at amortised cost. This will only be the case if it meets both the:

- Business model test; and
- 'SPPI' contractual cash flow characteristics test.

Furthermore, intercompany loan receivables don't qualify for the simplified approach to impairment available under IFRS 9, and so the general approach (commonly referred to as the three-bucket approach) must be applied when calculating the expected credit loss ('ECL').

These rules are complex enough to apply, but will prove particularly difficult in the absence of a contractual arrangement, as illustrated in the examples and explained in the sections that follow. However, depending on the lending scenario, there are actions that clients can take to make application easier and to demonstrate to their auditors that they have complied with the standard. In all cases, it should be remembered that a contractual arrangement may take different forms (written, oral, implied, explicit) but should have the following essential features:

Offer and Acceptance; Consideration; Intention to create legal relations; Certainty of terms.

Typical lending scenario	Client action
Written agreement - fixed term or repayable on-demand	Consider whether a demand feature is genuine if the lender does not intend, and the circumstances do not indicate, calling repayment for many years.
Oral or implied terms	Written confirmation of the terms to be provided to the lender's auditor by the borrower
No agreement of repayment terms	Agree and document formal terms (including obtaining confirmation from any shareholder providing a guarantee *(not a comfort letter)* or security) prior to the year-end so that either of the above scenarios can apply
DOCUMENTATION IS KEY IN DEMONSTRATING THE EXISTENCE AND TERMS OF A CONTRACT	

Meeting the tests to be accounted for at amortised cost

No specific issues should arise when an intercompany loan receivable has been made on normal commercial terms. Nor is an issue likely to arise in meeting the first 'business model' test. However,

questions may arise when considering the second ‘SPPI’ test when there are no formal terms, the terms are limited, or the terms are off-market.

These questions arise because the ‘SPPI’ test requires a loan to give rise to cash flows on ‘specified dates’ that are solely payments of principal and ‘interest on the principal amount outstanding’. In practice, it’s not always easy to determine the ‘specified date’ or what the return (if any) is as many group members lend to each other without any written agreement, or if written, are not explicit with respect to a repayment date(s), or the repayment date is contingent on a future event, eg the sale of investment properties, when cash flow allows, etc. Furthermore, loans without stated repayment terms are often considered repayable on-demand, and may be accompanied by non-binding comfort letters which can potentially affect the interpretation of or change/ create terms.

So, if some of these features exist, can the SPPI test be met? Yes, as in many cases these features are still consistent with a basic lending arrangement. For example:

- On-demand loans are repayable when demanded and so the ‘specified date’ is ‘when demanded’. (Note: Where it is assumed, in the absence of this being formally stated, that the loan is repayable on-demand, this ought to be documented between the parties).
- Even when timing of repayment is contingent on a specified event occurring, the repayment date is nevertheless ‘specified’ as being the contingent event.
- Where a contingent event only impacts the timing of repayment and not the contractual cash flows, then the SPPI test can still be met where the cash flows are solely principal and interest.
- Interest-free terms do not fail the SPPI test even though the contractual cash flows are just repayment of the principal. Principal is defined in IFRS 9 as the ‘fair value of the financial asset at initial recognition’ rather than the liquidated or par amount. Interest will therefore be imputed for accounting purposes, so that interest-free loans have both a principal and interest for IFRS 9 purposes (note: in respect of an on-demand loan the effective interest rate is zero).
- Off-market interest terms may not fail for similar reasons.

However, some more unusual terms may not be consistent with a basic lending arrangement; eg interest calculated by reference to the borrower’s profits will fail the SPPI test because the interest does not only compensate the lender for the time value of money and for assuming credit risk as a basic loan would do.

Calculating an impairment provision

ECLs are determined by taking into account the amount AND the timing of payments and by considering both the possibility of a credit loss occurring and the possibility that no credit loss occurs, even if the most likely outcome is no credit loss. For these reasons, an impairment provision will always exist, even for intercompany loans receivables that are repayable on-demand, although it may not be material.

However, there are also some practical challenges arising from the need to consider the timing of payments and the probability of a credit loss occurring when repayment terms are fluid or not explicit. For example:

- Determining when a default, such as becoming past due, occurs.
- Lack of comparable default patterns from other intercompany loan receivables to consider, and so greater reliance on current and forecast information.

Unless the borrower’s credit risk is considered low, it must be continually assessed during the expected life of the loan and if it increases significantly, lifetime ECLs must be recognised. This requirement can pose further practical challenges when repayment terms are fluid or not explicit. For example:

- Determining the expected life of the loan and thus the period over which to recognise ECLs.
- Is the expected life as long as the maximum contractual period, and does the borrower have an ability (even if only implied) to extend the contractual period?
- Use of past due information, and possible lack of ‘reasonable and supportable information’ to rebut the presumption in IFRS 9 that credit risk increases significantly when contractual payments are 30 days past due (IFRS 9.5.5.11).

The judgements needed to determine a ‘default’ policy, the expected life of the loan (and hence period of exposure to credit risk) and whether there has been a significant increase in credit risk, may be easier if clients make a distinction between on-demand, short-term and longer-term loans and this is documented as explained in the above table. Whatever approach is taken, clients need to be mindful of the fact that IFRS 9 presumes that default cannot occur later than when a financial asset becomes 90 days past due, unless there is reasonable and supportable information to corroborate a more lagging default criterion.

Where an intercompany loan receivable is accompanied by a guarantee or financial support from another group member, its existence is considered when measuring the ECL but not in assessing credit risk. This is because the ability to enforce the guarantee or financial support can reduce the amount of any credit loss suffered but it does not reduce the risk of the borrower actually defaulting. However, any changes in the quality of a guarantee or in the level of financial support are considered when assessing whether the borrower’s credit risk has significantly increased because these can impact the probability of default if say, support was to be provided to the borrower (rather than compensating the lender) to prevent it defaulting.

The resulting impairment must be recognised in profit or loss immediately, and cannot be added to the cost of investment or treated as a distribution. It is presented as a separate line in the income statement in accordance with IAS 1.82.

In summary

Classification is unlikely to be a significant issue for intercompany loan receivables.

However, the impairment provisions of IFRS 9 will be difficult to apply to those without formal repayment terms and so clients are **strongly** recommended to document their understanding of the lending arrangement to reflect its substance and so better enable the application of the standard. Implications for tax and distributable profits need consideration where clients also take the opportunity to restructure the loans.

The following examples illustrate how IFRS 9 might be applied in typical intercompany lending scenarios and where and how difficulties may arise.

Example 1 – impairment testing of an intercompany on-demand loan

Parent (P) makes an interest free loan of £1m to its subsidiary (S). There is a written agreement in place which provides that the loan is repayable on-demand. S has no other debt obligations or credit facilities, is adequately capitalised and has a current ratio of 1:1. Cash flow forecasts for the next 3 years indicate net cash inflows in each year.

The loan is initially measured at its fair value. As the loan is repayable on-demand, it's fair value is the transaction price and the effective interest rate (EIR) is zero.

Assessing probability of default and changes in credit risk

In determining a default event, P considers a range of factors that would indicate that the loan is in default, and not only when the loan is 90 days past due. The factors considered relevant are the availability of liquid assets when the loan is called.

In assessing whether an increase in credit risk relative to the position at initial recognition is indicated, P decides that the availability of liquid assets at the reporting date together with forward looking information is most relevant. Therefore, P decides to rely on its review of S's management accounts and cash flow forecasts when assessing credit risk. P judges that a current ratio of 0.8:1 or less or a forecast net outflow of cash in any of the next 3 years is an indication that credit risk has increased significantly.

However, whether there has been a significant increase in credit risk (which determines whether 12-month or lifetime ECLs apply) is largely irrelevant because the maximum period over which ECLs can be measured is the maximum contractual period (including extension options) over which the lender has a contractual obligation to extend credit. This is the period over which the entity is exposed to credit risk, and not a longer period. Given the loan is repayable on-demand, the maximum contractual period, and hence period of exposure to credit risk, is 1 day. Credit losses arising from the risk of a default that may occur after 1 day are not included.

Whilst tracking credit risk for an on-demand loan may not be relevant when measuring ECLs, whether there has been a significant increase in credit risk will be relevant for disclosure purposes (IFRS 7 requires qualitative and quantitative disclosures on the entity's credit risk exposure and significant credit risk concentrations).

How does P measure its impairment losses using the general approach?

At the reporting date, S's management accounts indicate that it does not have sufficient liquid assets to repay the loan. Accordingly, P estimates that the probability of default would be 100% because if demanded S would default.

In measuring the expected loss on default, P considers the expected manner of recovery. P judges that to maximise recovery of the loan it would allow S to continue trading for 2 years to fund repayment of the loan rather than arrange a fire sale of the less liquid assets.

Based on this strategy, and considering likely economic scenarios, P expects to recover £900k of the loan (note 1). This amount is arrived at after discounting the expected cash flows for each possible outcome over the 2-year period to the reporting date using the EIR. As the loan is repayable on-demand the EIR is zero and therefore the effect of discounting is nil (note 2).

P therefore recognises a loss of 100% x (£1m-£900k) = £100k.

Notes:

1. *The £900k reflects the probability-weighted amount after evaluating an unbiased range of possible outcomes. It reflects neither a worst-case nor a best-case scenario and therefore the amount of the loss*

can never be 100% or 0%; instead it must reflect both the possibility that a credit loss occurs and the possibility that no credit loss occurs even if this is very low (IFRS 9.5.5.17a and 18, B5.5.41-43).

2. *IFRS 9.5.5.17b requires the outcomes to reflect the expected timing of recovery (in this case, 2 years past due). Had the EIR in this example been other than zero, the effect of discounting would impact the amount of the impairment. However, such effect may be immaterial over a 2-year period.*

Example 2 – impairment testing of an intercompany term loan with fixed terms and guarantee

Parent (P) has 2 wholly owned subsidiaries (B) and (C). B makes a loan of £1m to its sister C. The written terms are that the loan is repayable in 4 years' time and in the meantime interest is payable at a market rate of 10% per annum. There are no prepayment or extension options.

C has no other debt obligations or credit facilities and is adequately capitalised. C is key in the strategy of the group and therefore P provides a guarantee to B if C defaults. P is in a strong position to be able to meet the guarantee should it be necessary. However, C is currently forecasting positive cash flows before interest throughout the term of the loan that will cover a 1/4 of the loan by a factor of 1.5 in each year so that it will easily repay the loan at the end of the term and meet the annual interest payments ('cash flow cover').

The loan is initially measured at its fair value, which is £1m because interest is payable at a market rate.

Assessing probability of default and changes in credit risk

In determining a default event, B judges that the cash flow cover expectation is a relevant indicator of default.

In assessing whether an increase in credit risk relative to the position at initial recognition is indicated, B decides that forward looking information is most relevant given the repayment terms. This is because repayment is back-ended which makes past behavioural patterns less relevant. However, it will also consider past as well as forecast cash flow cover. Therefore, B decides to rely on a review of C's cash flow forecasts when assessing credit risk and an assessment based on historical and forecast cash flow cover. B judges that an increase in the risk of default occurring is significant if the annual cash flow cover achieved is only 1 times a 1/4 of the loan and the updated forecasts indicate that this will not improve over the remainder of the term.

The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period. B notes that this is 4 years because this is the maximum term of the loan and there are no prepayment or extension options.

Initial recognition:

B estimates at initial recognition that there is a 1% probability of default over the expected life of the loan. The probability of default is considered low because the forecasts are prudent and the level of headroom is high.

B estimates that should default occur, the most likely scenario is that it will recover its loan in full because of P's guarantee. However, B must measure the ECL considering a range of economic scenarios that reflect the possibility that either P will honour the guarantee or will not be able to either in part or full. The ECL should also take into account the timing of cash flows, and B estimates that should it need to call in the guarantee that this process would take 2 months (note 1).

How does P measure its impairment losses using the general approach?

End of year 1:

B considers the factors in IFRS 9. B5.5.22, and concludes that credit risk is low at the reporting date and therefore the requirements to be able to use the simplification in IFRS 9.5.5.10 are met (note 3). Accordingly, B can assume that there has not been a significant increase in credit risk since initial recognition. B decides to use the simplification, and recognises 12-month ECLs.

B estimates that there is a 0.2% probability of 'default' in the next 12 months and that on default it would recover £950k of the loan (notes 1 and 2).

B therefore recognises a loss of 0.2% x (£1m-£950k) = £100.

It is concluded that this amount is not material.

End of year 2:

B reviews C's forecasts and observes that they have been revised downwards. C is forecasting a decline in the demand for its sales product due to a deterioration in economic conditions and considers that this may affect its ability to repay the loan due in 2 years' time because an outflow of cash is anticipated in the following year.

Without P's guarantee, B would no longer be able to assume that credit risk remains low due to the deterioration in economic conditions since initial recognition – in this scenario, the loan would move from stage 1 to stage 2 of the general approach and B would be required to recognise lifetime ECLs.

However, IFRS 9 B5.5.17(k) notes that one factor that should be assessed in determining whether there has been a significant increase in credit risk is the change in quality of a shareholder guarantee where the shareholder has an incentive and the financial ability to prevent a default by capital or cash infusion.

Having reviewed P's financial position and discussed the issue of C with P, B determines that C remains integral to P's group strategy and concludes that P's incentive and financial ability to prevent C defaulting has not reduced since initial recognition. B therefore concludes that there has been no significant increase in credit risk despite C's worse forecasts, and continues to recognise 12-month ECLs.

B estimates that the probability of 'default' in the next 12 months has increased to 0.6% and that on default it would now recover £850k (notes 1 and 2).

B therefore recognises a loss of 0.6% x (£1m-£850k) = £900.

End of year 3:

B reviews C's forecasts and observes that whilst the decline in demand for its sales product seems to have halted and indeed growth is forecast for the next year (albeit lower than forecast at original recognition), it is not expected to recover sufficiently to enable repayment of the loan that is due in the next 12 months. The loan is therefore considered to be credit impaired.

B determines that P's own financial ability has also declined. B estimates that the probability of default over the final year of the loan has increased to 60%, and that on default it will only recover £700k taking into account recovery under the guarantee (notes 1 and 2).

B revises its loss provision to 60% x (£1m-£700k) = £180k.

Notes:

The amount to be recovered reflects the probability-weighted amount after evaluating an unbiased range of possible outcomes. It reflects neither a worst-case nor a best-case scenario and therefore the amount of the loss can never be 100% or 0%; instead it must reflect both the possibility that a credit loss occurs and the possibility that no credit loss occurs even if this is very low (IFRS 9.5.5.17a and 18, B5.5.41-43). The range of possible outcomes would likely consider whether the guarantee would be needed, and if so how much of it may be recovered under the guarantee. In measuring these cash flows, B needs to consider the credit risk of both C and P.

IFRS 9.5.5.17b requires the outcomes to reflect the expected timing of recovery (in this case, 2 months past due). In this example, discounting would be at 10%.

If B had been unable to conclude that credit risk was low, B would need to consider whether there has been a significant increase in credit risk. In such a scenario, B would not be able to use the simplification available in IFRS 9. B5.5.13 to assess changes in the risk of a default occurring over the next 12 months (even though the expected life is longer) as a proxy in determining whether credit risk has increased. This is because the significant repayments are expected beyond the next 12 months (at the end of year 4).

Example 3 – impairment testing of an intercompany term loan with fluid terms

Parent (P) makes an interest free loan of £1m to its subsidiary (S). There is no written agreement, but the parties have documented in writing for the auditor, their understanding of the terms and this is supported by cash flow forecasts. The understanding is that the loan could be repaid in around 3 years, as working capital permits, but may be extended to the end of year 6. S has no other debt obligations or credit facilities and is adequately capitalised. Repayments are forecast to begin slowly during year 2 and increase throughout year 3.

The loan is initially measured at its fair value, which is determined to be £840,000.

Assessing probability of default and changes in credit risk

In determining a default event, P judges that 'days past due' will not be a relevant indicator due to the fluid terms of repayment. P therefore develops a policy on default that considers qualitative factors such as the expected life of the loan and the level of headroom in the cash flow forecasts of S. P judges based on the documented understanding and initial forecasts, that the period it expects to have credit risk exposure for is 3 years, and that if the loan is not fully repaid within 6 years it will consider the loan to be credit impaired.

In assessing whether an increase in credit risk relative to the position at initial recognition is indicated, P decides that forward looking information is most relevant given the repayment terms. This is because the fluid terms and the expectation that repayments will most likely be back-ended make past behavioural patterns less relevant. Therefore, P decides to rely on its review of S's cash flow forecasts when assessing credit risk. P judges that an increase in credit risk is significant if the expected life of the loan is extended by more than 1 year, or that less than 1/3 of the loan can be recovered by the end of year 3.

The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period. P judges that in substance the loan contains an option for S to extend the contractual period, but not beyond year 6, if working capital does not permit repayment as forecast, and that it would be contractually required to continue extending credit.

Initial recognition:

P estimates at initial recognition that there is a 5% probability of default over the expected life of the loan. The probability of default (i.e. that the expected life of the loan may be extended or that it will not be possible to recover at least 1/3 of the loan by the end of year 3) is considered low because the forecasts are prudent and the level of headroom is high. P considers that on default, the most likely scenario is that it will not get back any of the loan. However, P must measure the ECL considering a range of economic scenarios that also reflect the possibility that it may be able to recover something even if that possibility is very low (note 2).

How does P measure its impairment losses using the general approach?

End of year 1:

No repayments were forecast in year 1. S's forecasts at the end of year 2 indicate that repayments will be able to commence and continue as originally anticipated.

P considers the factors in IFRS 9. B5.5.22, and concludes that credit risk is low at the reporting date and therefore the requirements to be able to use the simplification in IFRS 9.5.5.10 are met. Accordingly, P can assume that there has not been a significant increase in credit risk since initial recognition. P decides to use the simplification, and recognises 12-month ECLs (note 1).

P estimates that there is a 2% probability of 'default' in the next 12 months and that on default the probability-weighted amount it would recover taking into account the timing of recovery would be £50k (notes 2 and 3).

P therefore recognises a loss of 2% x (£1m-£50k) = £19,000.

End of year 2:

P reviews the forecasts of its subsidiary and observes that S has revised down its cash flow forecasts. S now expects a decline in the demand for its sales product because of a significant shift in technology and considers that this may affect its ability to make repayments on the loan from P as originally forecast. P is no longer able to assume that credit risk remains low due to the technological changes since initial recognition.

Although credit risk is now not low, P considers that the increase in credit risk is not significant because the forecasts indicate that a 1/3 of the loan can still be recovered in year 3, with the loan being fully recovered by the end of year 4.

Accordingly, P continues to recognise 12-month ECLs.

P now assesses that the probability of 'default' in the next 12 months has increased to 3%, and that on default the probability-weighted amount it would recover taking into account the timing of recovery would still be £50k (notes 2 and 3).

P therefore revises its impairment provision to 3% x (£1m-50k) = £28,500.

End of year 3:

P observes that £250k of the loan has been recovered. P reviews the forecasts of its subsidiary and observes that the expected decline in demand for its sales product is expected to occur much more quickly than was anticipated in the previous year. S now considers that this will significantly affect its ability to make further repayments on the loan from P in the revised timeframe expected at the end of year 2.

P considers that there has been a significant increase in credit risk due to the forecasts of S indicating that it will now have to wait 5 years before recovering its loan in full, rather than the 3 years expected on initial recognition. The loan therefore moves from stage 1 to stage 2 of the general approach and consequently P now recognises lifetime ECLs.

P estimates that the probability of 'default' over the remaining expected life of the loan has increased to 25% and that on default the probability weighted amount expected to be recovered is £50k and therefore the amount of loss would be £700k (notes 2 and 3).

P therefore revises its impairment provision to 25% x (£1m-£250k recovered – possible recovery of £50k) = £175k.

Notes:

1. *The use of the simplification requires significant judgement in this scenario because of the need to consider credit risk from a market participant's perspective considering all the terms and conditions of the financial instrument, whereas the intercompany loan in this example has been made on non-market and informal terms. However, as the ability to repay is supported by strong forecasts, P judges, to illustrate the availability of the simplification, that it can conclude that credit risk is low. If P had been unable to conclude that credit risk was low, P would need to consider whether there has been a significant increase in credit risk. In such a scenario, P would not be able to use the simplification available in IFRS 9. B5.5.13 to assess changes in the risk of a default occurring over the next 12 months (even though the expected life is longer) as a proxy in determining whether credit risk has increased. This is because the significant repayments are expected beyond the next 12 months (in year 3).*

2. *The amount to be recovered reflects the probability-weighted amount after evaluating an unbiased range of possible outcomes. It reflects neither a worst-case nor a best-case scenario and therefore the*

amount of the loss can never be 100% or 0%; instead it must reflect both the possibility that a credit loss occurs and the possibility that no credit loss occurs even if this is very low (IFRS 9.5.5.17a and 18, B5.5.41-43).

3. *IFRS 9.5.5.17b requires the outcomes to reflect the expected timing of recovery.*