PITCHER PARTNERS

June 2023

Financial reporting guide

Impairment of intercompany loan balances

This publication provides a high-level summary of the expected credit loss impairment model under AASB 9 *Financial Instruments* (AASB 9), and the application of that model to intercompany loan balances.

Scope and objective

The impairment requirements of AASB 9 apply primarily to debt instruments measured at amortised cost, such as loan balances, trade receivables and lease receivables, and debt instruments measured at fair value through other comprehensive income.

Intercompany loan balances are classified as debt instruments and, consequently, all intercompany loan balances (recorded as a financial asset by the lender) measured at amortised cost are subject to the impairment requirements of AASB 9.

For those financial assets that are subject to the impairment requirements of AASB 9, an entity is required to recognise expected credit losses from the date of initial recognition of the financial asset and throughout the life of financial asset (i.e., until derecognition of the financial asset).

What are ‘credit losses’ and ‘expected credit losses’?

A **‘credit loss’** is the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit impaired financial assets).

When measuring a ‘credit loss’, an entity is required to estimate cash flows by considering all contractual terms of the financial instrument (e.g., prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows considered, when measuring a ‘credit loss’, include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms.

‘Expected credit losses’ (ECLs) are the weighted average of ‘credit losses’ with the respective risks of a default occurring as the weights.

An entity is required to measure ECLs in a way that reflects:

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. Consequently, at a minimum, an entity would consider the probability that a credit loss would occur and the probability that no credit loss would occur, even if the probability of a credit loss occurring was very low;
- the time value of money; and
- reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

What is the required approach for measuring ECLs?

AASB 9 provides two approaches for measuring ECLs:

- the 'general approach'; and
- the 'simplified approach'.

The **general approach** involves an entity classifying financial assets (that are subject to the impairment requirements of AASB 9) into one of three possible 'stages' of credit risk – 12-month ECLs, lifetime ECLs or credit impaired – and measure the ECLs and interest income consistent with the requirements applicable to the stage.

More information about the 'general approach' for the recognition of ECLs is contained in Financial Reporting Guide - *Impairment of Financial Assets – 'general approach'*.

The **simplified approach** combines the first two stages of the general approach and consequently comprises only two stages – lifetime ECLs and credit impaired. The simplified approach must be applied to trade receivables and contract assets (that result from transactions within the scope of AASB 15 *Revenue from Contracts with Customers*) that do not contain a significant financing component. In addition, an entity can choose to apply the simplified approach to trade receivables and contract assets that do contain a significant financing component, and also to lease receivables (that result from transactions within the scope of AASB 16 *Leases*).

More information about the 'simplified approach' for the recognition of ECLs is contained in Financial Reporting Guide - *Impairment of Trade Receivables*.

Applying the impairment requirements of AASB 9 to intercompany loan balances

As outlined above, when a debt instrument is subject to the impairment requirements of AASB 9, unless the instrument is a trade receivable, contract asset or lease receivable, the 'general approach' for the recognition of ECLs must be applied.

Accordingly, for intercompany loan arrangements, the lending entity (recording the financial asset) must apply the 'general approach' for the recognition of ECLs. Under the 'general approach', the lending entity is required to recognise either:

- **12-month ECLs** - the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. 12-month ECLs are recognised when the lending entity assesses that the credit risk on the intercompany loan has not increased significantly since initial recognition; or
- **Lifetime ECLs** - the expected credit losses that result from all possible default events over the expected life of a financial instrument. Lifetime ECLs are recognised when the lending entity assesses that the credit risk on the intercompany loan has increased significantly since initial recognition.

AASB 9 outlines the principles that must be applied when considering whether a debt instrument has experienced a significant increase in credit risk since initial recognition, together with a non-exhaustive list of identifying factors or indicators of a significant increase in credit risk.

More information about assessing whether a debt instrument has experienced a significant increase in credit risk is contained in Financial Reporting Guide - *Impairment of Financial Assets – 'general approach'*.

The following pages of this Financial Reporting Guide outline some practical considerations to keep in mind when applying the 'general approach' to intercompany loans.

Consideration 1: **Intercompany loans due within 12-months or less of reporting date**

For intercompany loans that are due to be settled within 12-months or less after the reporting date, 12-month ECLs are the same as lifetime ECLs.

The practical impact for the measurement of ECLs is that the lending entity (recording the financial asset) simply records an allowance for ECLs, equal to lifetime ECLs, against the year-end carrying amount of the intercompany loan, without the need to assess whether the credit risk on the loan has increased significantly since initial recognition.

***Consideration 2:* Intercompany loans that are repayable on demand and interest free**

It is common for intercompany loans to be repayable on demand and interest free.

As noted in *consideration 1*, above, for intercompany loans that are due to be settled within 12-months or less after the reporting date, 12-month ECLs are the same as lifetime ECLs. As such, it is not necessary for the lending entity to assess whether the credit risk on the loan has increased significantly since initial recognition.

However, what are some of the additional matters to consider in relation to intercompany loans that are repayable on demand and interest free?

In accordance with AASB 9, the maximum period over which expected credit losses shall be measured is the maximum contractual period over which the entity is exposed to credit risk. Because the intercompany loan is repayable on demand, the maximum contractual period over which the lending entity is exposed to credit risk is very short (i.e., the period required to transfer funds, once the demand for repayment is made).

Therefore, when measuring an allowance for ECLs at reporting date, ECLs must be measured on the basis that repayment of the intercompany loan is demanded at reporting date. This basis must be applied (in order to comply with the requirements of AASB 9), irrespective of the intended or expected timing of an actual demand for repayment.

If the borrower has the capacity to repay the intercompany loan, if repayment is demanded at reporting date, an allowance for ECLs would be close to $zero at reporting date. If however the borrower does not have the capacity to repay the intercompany loan, if repayment is demanded at reporting date, the lending entity should consider the expected manner, timing and extent of recovery of the intercompany loan when measuring an allowance for ECLs at reporting date.

A common strategy for the repayment of an ‘on demand’ intercompany loan is for the lending entity to allow the borrower more time to repay the loan. If this strategy is adopted and the borrower has the capacity to repay the loan in the future, an allowance for ECLs recorded at reporting date will be limited to the impact of discounting (i.e., present valuing) the future settlement amount, from the expected settlement date to the reporting date, using the original effective interest rate.

The ‘effective interest rate’ is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.

For an intercompany loan that is repayable on demand and interest free, the original effective interest rate is zero%. A zero% original effective interest rate has no impact on the present value calculation. Consequently, so long as the borrower has the capacity to repay the ‘on-demand, interest free’ loan at a future time and the lending entity allows the borrower time to repay in full, an allowance for ECLs would be close to $zero at reporting date.

This scenario is illustrated in Example 1.

Example 1

On 1 July 2022, PP Ltd provides loan funding of $5 million to its subsidiary YY Pty Ltd. The intercompany loan is repayable on demand and interest free. At initial recognition, PP Ltd records the intercompany loan at a carrying amount of $5 million (equal to its fair value, reflecting the ‘repayable on-demand’ feature).

At the date of initial recognition (1 July 2022), the rate that exactly discounts the estimated future cash receipts ($5 million) through the expected life of the intercompany loan to the gross carrying amount ($5 million) is zero%. I.e., the original effective interest rate is zero%.

At 30 June 2023 (reporting date), repayment of the loan has not been demanded and the carrying amount of the loan (recorded by PP Ltd) is $5 million. PP Ltd assesses that subsidiary YY Pty Ltd does not have the capacity to repay the loan, if repayment was demanded at 30 June 2023. However, PP Ltd further assesses that subsidiary YY Pty Ltd has the capacity to repay the loan in the future, following the disposal of an investment property (expected to occur in the second half of FY 27).

On the basis of this information, the present value of the estimated future cash receipts of $5 million (expected to be received in the second half of FY 27) at the original effective interest rate of zero%, is $5 million.

As there is no difference between the contractual cash inflows and the expected cash inflows, discounted at the original effective interest rate, PP Ltd will record an allowance for ECLs of close to $zero at 30 June 2023.

***Consideration 3:* ‘Low credit risk’ intercompany loans due more than 12-months after reporting date**

For intercompany loans that are due to be settled more than 12-months after reporting date, the lending entity (recording the financial asset) is required to recognise an allowance for ECLs equal to either:

- **12-month ECLs**, if the entity assesses that the credit risk on the loan has not increased significantly since initial recognition; or
- **lifetime ECLs**, if the entity assesses that the credit risk on the loan has increased significantly since initial recognition.

However, if the intercompany loan is determined to have low credit risk at reporting date, the lending entity is permitted to assume that the credit risk on that loan has not increased significantly since initial recognition.

The credit risk on a financial instrument is considered low, if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations.

If the lending entity determines that the intercompany loan has low credit risk at reporting date, the lending entity recognises an allowance for ECLs equal to 12-month ECLs.

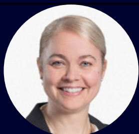
***Consideration 4:* Equity investments in subsidiaries, joint venture entities and associates**

For completeness, it’s important to remember that equity investments in subsidiaries, joint venture entities and associates are not within the scope of the impairment requirements of AASB 9.

However, subject to the measurement basis applied by the investor, equity investments in subsidiaries, joint venture entities and associates may be subject to the impairment requirements of other Australian Accounting Standards.

For example, when an equity investment in a subsidiary, joint venture entity or associate is measured at cost in the separate financial statements of the investor (under AASB 127 *Separate Financial Statements*), the equity investment is subject to the impairment requirements of AASB 136 *Impairment of Assets* (AASB 136).

If AASB 136 is applicable, and there is an indication that an equity investment in a subsidiary, joint venture entity or associate may be impaired at reporting date, the investor is required to determine the investment’s ‘recoverable amount’ (being the higher of its fair value less costs of disposal and its value in use). If the carrying amount of the investment exceeds its recoverable amount at reporting date, the investor is required to recognise an impairment loss.



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