In brief
A look at current financial reporting issues

[09] February 2018

IFRS 9 impairment: inter-company loans in separate financial statements

At a glance

IFRS 9 introduces an 'expected loss' model for recognising impairment of financial assets held at amortised cost, including most inter-company loans receivable. This is different from IAS 39, which had an 'incurred loss' model, where provisions were recognised only when there was objective evidence of impairment.

This change of approach will require lenders of inter-company loans to consider forward-looking information to calculate expected credit losses, regardless of whether there has been an impairment trigger. In some cases, impairment losses might be recognised where none were previously.

Issue

IFRS 9 requires entities to recognise expected credit losses for all financial assets held at amortised cost, including inter-company loans from the perspective of the lender. IAS 39, the previous standard for assessing impairment of inter-company loans, had an incurred loss model.

This change of approach might result in impairment losses being recognised where none were previously. However, it is expected that many inter-company loans within the scope of IFRS 9 might not require a material impairment provision to be recognised, because:

- they are repayable on demand and the lender expects to be able to recover the outstanding balance of the loan if demanded;
- they are low credit risk, so 12-month expected credit losses can be calculated, which might not be material; or
- they have not had a significant increase in credit risk since the loan was first recognised, or have a remaining life of less than 12 months, so 12-month expected credit losses are calculated, which, as noted above, might not be material.

Where inter-company loans do not meet any of the three criteria above, lifetime expected credit losses will need to be calculated, which are more likely to give rise to a material impairment provision.

This In brief summarises our practical guidance in In depth 2018-02, 'IFRS 9 impairment practical guide: inter-company loans in separate financial statements', on how to apply IFRS 9's impairment requirements to inter-company loans.

The appended decision tree and commentary will direct you to the relevant section of the In depth guidance, to assess whether a material impairment provision is required for your inter-company loans.

Irrespective of whether calculating expected credit losses for inter-company loans gives rise to a material impairment provision, entities will need to ensure that their approach and the relevant assumptions made are documented.

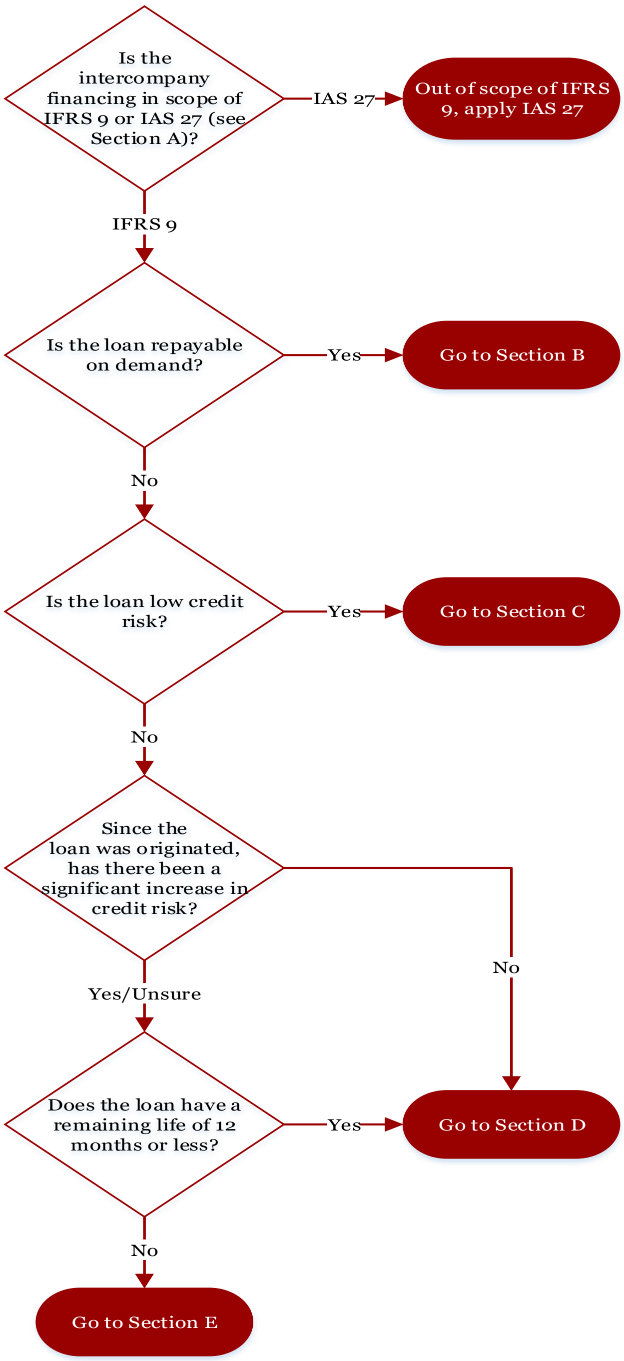
Where can further information be found?

PwC's In depth 'IFRS 9 impairment practical guide: inter-company loans in separate financial statements' provides guidance on IFRS 9's impairment requirements for inter-company loans.

Alternatively, contact Sandra Thompson (sandra.j.thompson@pwc.com), Jessica Taurae (jessica.taurae@pwc.com) or Louise Brown (louise.brown@pwc.com) for further information.

Appendix – Decision tree and commentary

Use the following decision tree to direct you to the relevant section of the In depth, and commentary below, to determine if a material impairment provision is required:



In depth Section	Common Example	Commentary
Section A *Is the loan in the scope of IFRS 9?*	Lender accounts for the inter-company financing as an 'investment in subsidiary' under IAS 27. Borrower accounts for the financing received as a capital contribution.	• Inter-company financings that, in substance, form part of an entity's 'investment in a subsidiary' are not in IFRS 9's scope. Rather, IAS 27 applies to such investments. • An inter-company loan is outside IFRS 9's scope (and within IAS 27's scope) only if it meets the definition of an equity instrument for the subsidiary (for example, it is a capital contribution). • All loans to subsidiaries that are accounted for by the subsidiary as a liability are within IFRS 9's scope. • If the terms of an intra-group financing are clarified or changed on adoption of IFRS 9, careful analysis might be required.
Section B *Loan is repayable on demand*	Inter-company loan is repayable on demand. The borrower does not have sufficient available liquid assets to repay the inter-company loan if it was demanded at the reporting date. However, if the lender demanded repayment of the inter-company loan, it would allow the borrower to continue trading/sell its assets to fund repayment of the loan over a period of time, to maximise recovery of the loan.	• For loans that are repayable on demand, expected credit losses are based on the assumption that repayment of the loan is demanded at the reporting date. • If the borrower has sufficient accessible highly liquid assets in order to repay the loan if demanded at the reporting date, the expected credit loss is likely to be immaterial. • If the borrower could not repay the loan if demanded at the reporting date, the lender should consider the expected manner of recovery to measure expected credit losses. This might be a 'repay over time' strategy (that allows the borrower time to pay), or a fire sale of less liquid assets. • If the recovery strategies indicate that the lender would fully recover the outstanding balance of the loan, the expected credit loss will be limited to the effect of discounting the amount due on the loan (at the loan's effective interest rate, which might be 0% if the loan is interest free) over the period until cash is realised. If the time period to realise cash is short or the effective interest rate is low, the effect of discounting might be immaterial. If the effective interest rate is 0%, and all strategies indicate that the lender would fully recover the outstanding balance of the loan, there is no impairment loss to recognise.
Section C *Loan has low credit risk*	The borrower of the inter-company loan has a strong capacity to meet its contractual cash flow obligations in the near term. Any adverse changes in economic and business conditions in the longer term will not necessarily reduce the borrower's ability to repay the loan.	• A loan has low credit risk if 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 might, but will not necessarily, reduce the ability of the borrower to fulfil its obligations. • For loans that are low credit risk at the reporting date, IFRS 9 allows a 12-month expected credit loss to be recognised. • An external rating of 'investment grade' is an example of low credit risk. However, an intra-group loan should not be assumed to have the same rating as other instruments issued by the borrower (such as loans to third parties) without further analysis. • Low credit risk loans might have very low risk of default (or 'probability of default' (PD)). • A 'short-cut' can be used to determine if the expected credit loss on a low credit risk loan needs to be recognised. This short-cut assumes that the PD for the inter-company loan is that of the lowest investment grade (either BBB- or Baa3, depending on the credit ratings agency used) and the maximum possible loss in the event of a default (that is, the loan is fully drawn and no amount is recovered). If this results in an immaterial expected credit loss, no further work is required. If, however, this short-cut results in a material expected credit loss, further work will be required to estimate both the actual PD and the actual loss in the event of a default.
Section D *No significant increase in credit risk since the loan was originated, or remaining life is less than 12 months*	Inter-company loan is a 'quasi equity' loan and the lender is unable to determine that the loan is low credit risk. However, since the loan was first granted, there have not been any actual or expected significant adverse changes in the operating results of the borrower, nor any actual or expected significant adverse changes in the regulatory, economic or technological environments of the borrower. The inter-company loan is not 30 days past due.	• For loans where there has not been a significant increase in credit risk (that is, where they are in stage 1), a 12-month expected credit loss is recognised. • A similar short-cut could be used as for low credit risk loans to determine if the expected credit loss on a stage 1 loan is material. This short-cut assumes the maximum possible loss in the event of a default (that is, the loan is fully drawn and no amount is recovered). If, when the PD is applied to the outstanding balance of the inter-company loan, this results in an immaterial expected credit loss, no further work is required. If, however, this short-cut results in a material expected credit loss, further work will be required to estimate the actual loss in the event of a default.
Section E *Other inter-company loans*	Inter-company loan does not fall into any of the categories above (that is, it has had a significant increase in credit risk since it was first recognised).	• For loans that are in stage 2 or 3, a lifetime expected credit loss is recognised. • In measuring the expected credit loss, all reasonable and supportable information that is available without undue cost or effort should be considered. This includes both internal and external information, and information about past events, current conditions and forecasts of future economic conditions. • The effect of credit enhancements such as collateral, guarantees and letters of support should also be considered. Guarantees that are contractually enforceable have a greater effect than letters of support that are not. • Calculating lifetime expected losses can be complex. If support is required, consult with an IFRS 9 specialist.