



IFRS IN PRACTICE 2019

Applying IFRS 9 to Related Company Loans

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1. INTRODUCTION

IFRS 9 *Financial Instruments* makes no distinction between unrelated third party and related party transactions. Entities that prepare stand-alone financial statements are required to apply the full provisions of the standard to all transactions within its scope.

This means related company loan receivables must be classified and measured in accordance with the requirements of IFRS 9, including where relevant, applying the Expected Credit Loss (ECL) model for impairment.

Applying IFRS 9 to related company loans can present a number of application challenges as they are often advanced on terms that are not arms-length or sometimes advanced on an informal basis without any terms at all. In addition, they can contain features that expose the lender to risks that are not consistent with a basic lending arrangement. This publication sets out a summary of the key requirements of IFRS 9 (focusing on those that are likely to be most relevant to related company loans) and uses examples to illustrate how these requirements could be applied in practice.

BDO comment – Stand-alone financial statements

Stand-alone financial statements include:

- *Separate financial statements – Entity only financial statements;*
- *Individual financial statements – Entity that has one or more associate(s) or joint venture(s) but no subsidiaries and is required to prepare financial statements in which the associate(s) or joint venture(s) is/are equity accounted); and*
- *Consolidated financial statements of a subgroup that forms part of a wider group.*

For further and more detailed guidance on all aspects of IFRS 9, please refer to 'IFRS in Practice: IFRS 9 Financial Instruments' which is available on the [BDO Global IFRS webpage](#).

2. COMMON EXAMPLES AND KEY CONSIDERATIONS

Related company loans include loans between a parent and a subsidiary or between fellow subsidiaries (i.e. intragroup loans) as well as loans to associates or joint ventures (including those long terms interests that form part of the net investment in accordance with IAS 28 *Investments in Associates and Joint Ventures*).

Provided related company loans are entered into on terms that are consistent with an arms-length lending transaction, applying IFRS 9 should not present any additional complexity than it would for third party loans. However, this is often not the case for related company loans. The following types of arrangements are relatively common:

- Loans advanced on an interest-free basis or at a rate of interest that is not considered arms-length;
- Loans advanced on an interest-free basis that are repayable on demand but where recovery is neither planned nor expected for some years;
- Loans advanced to an entity with insufficient equity or resources to allow for its repayment or where the repayment is linked to underlying asset performance; and
- Loans advanced on an undocumented basis – i.e. with no contractual terms.

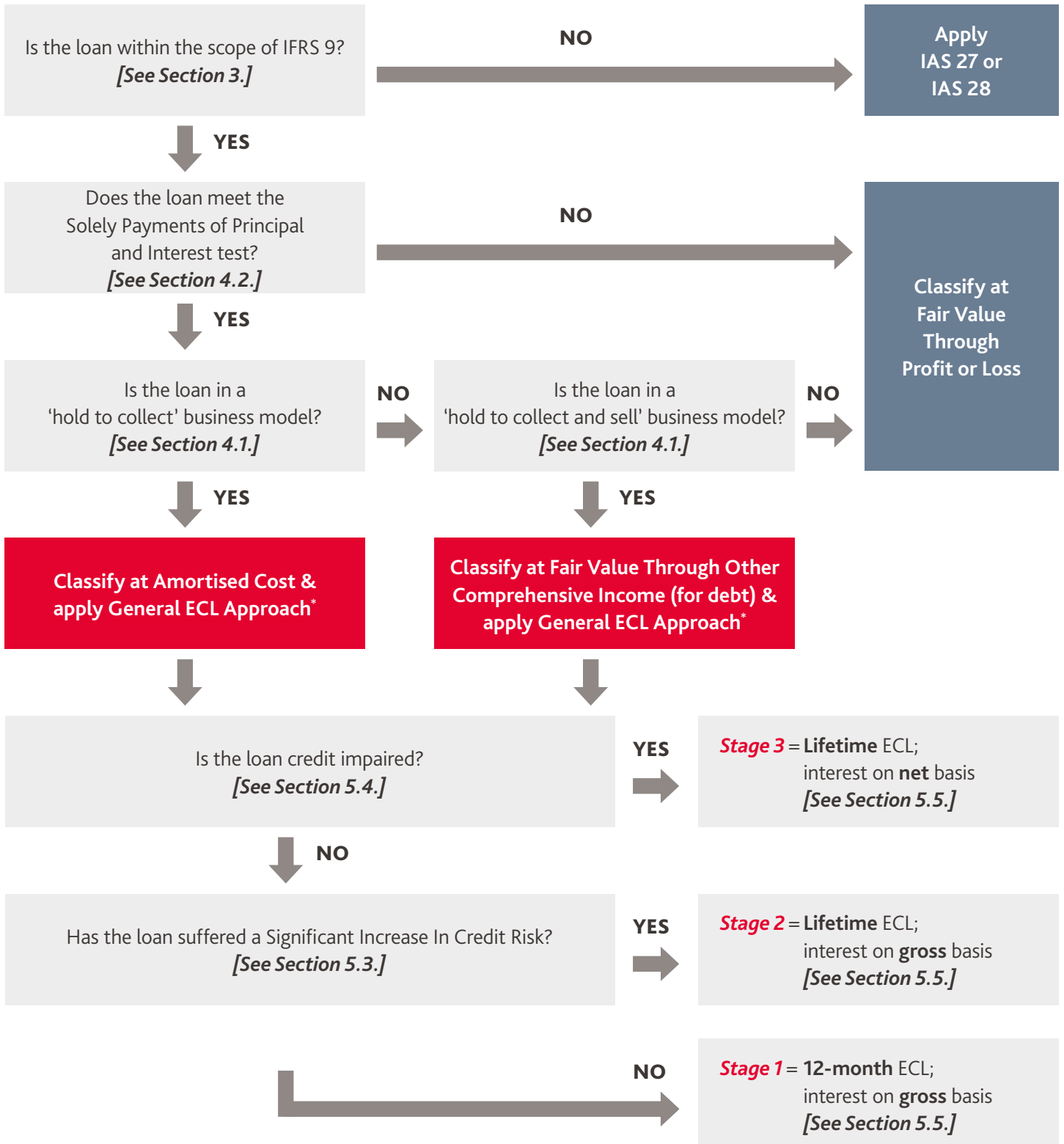
Applying IFRS 9 to these types of related company loan receivables can be complex and requires careful analysis.

BDO comment – Potential implications for distributable profits

In contrast to loans to associates and joint ventures, loans between group entities will eliminate upon consolidation. However, entities should remember that the IFRS 9 impairment provision amount will directly affect the individual entity's retained earnings and as such the profits that are available for distribution in some jurisdictions.

The following decision tree illustrates the key areas that entities will need to consider:

Key areas of consideration



* The General Approach is applied unless the loan is Purchased or Originated Credit Impaired (see Appendix A). These requirements are outside the scope of this publication.

BDO comment – Other transactions within the scope of IFRS 9

This publication focuses on applying the requirements of IFRS 9 to certain types of related company loan receivables. However, entities should be aware that the requirements of IFRS 9 also apply to other types of related company transactions that can arise in the normal course of business, namely:

- **Trade receivables** under IFRS 15 Revenue from Contracts with Customers are required to be **classified and measured** in accordance with IFRS 9 similar to any other financial asset; those that are not classified at Fair Value through Profit or Loss (FVPL) are within the scope of the **ECL model** (Simplified Approach is either permitted or, in some cases, required);
- **Contract assets** under IFRS 15 are within the scope of the **ECL model** (Simplified Approach is either permitted or, in some cases, required);
- **Lease receivables** under IFRS 16 Leases are within the scope of the **ECL model** (Simplified Approach permitted);
- **Issued financial guarantee contracts** (FGCs) that are not classified at FVPL (and not accounted for in accordance with IFRS 4 Insurance Contracts or IFRS 17 Insurance Contracts) are within the scope of the **ECL model** (General Approach required); and
- **Issued loan commitments** that are not classified at FVPL are within the scope of the **ECL model** (General Approach required).

In addition, other related party loan receivables, such as loans to an entity's key management personnel must also be classified and measured in accordance with IFRS 9, including, where relevant applying the ECL model.

3. SCOPE CONSIDERATIONS

Before considering how to apply the requirements of IFRS 9 to related company loans, entities must first consider whether the loan is within the scope of IFRS 9 or another standard. This is because IFRS 9: 2.1(a) scopes out 'interests in subsidiaries, associates and joint ventures' that are accounted for in accordance with IAS 27 *Separate Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures* i.e. at cost less impairment or using the equity method.

In many cases, it will be clear that the loan is a debt instrument that falls within the scope of IFRS 9 but some scenarios may require a more detailed analysis.

3.1. Loans for which settlement is neither planned nor likely

If an entity has minimal equity and is financed almost entirely through a loan, the nature of that loan may seem more akin to a capital contribution i.e. part of the interest in the subsidiary, associate or joint venture that is scoped out of IFRS 9. This is particularly the case if settlement of the loan is not planned or likely to occur for some time.

IAS 28 makes specific reference to items of this nature referring to them as long-term interests in an associate or joint venture. These are items for which settlement is neither planned nor likely to occur in the foreseeable future that in substance form part of the net investment in the associate or joint venture such as preference shares, long-term receivables or loans.

In October 2017, the IASB amended IAS 28 to clarify that IFRS 9 must be applied to long-term interests in an associate or joint venture to which the equity method is not applied. The equity method is applied to those instruments that give the holder a right to the share of net assets of the investee. Although losses may be applied to long-term interests in certain circumstances (see IAS 28: 38), this is not application of the equity method because it is an application of losses, and not of all changes in net assets. This means that an entity must first apply the requirements in IFRS 9 to that long-term interest (including, where relevant, the impairment requirements) and then apply both the loss allocation and impairment requirements in IAS 28¹.

This amendment has clarified that if the instrument meets the definition of a liability from the perspective of the issuer, and is not otherwise considered part of the interest in the associate or joint venture that is accounted for in accordance with IAS 28², it is within the scope of IFRS 9.

BDO comment – Similar loans advanced to subsidiaries

While the IAS 28 amendment focused only on long-term interests in an associate or joint venture, the conclusions reached are likely to be equally applicable to instruments of a similar nature advanced to subsidiaries. Therefore, if the instrument meets the definition of a liability from the perspective of the issuer and is not otherwise considered part of the interest in the subsidiary that is accounted for in accordance with IAS 27², it is within the scope of IFRS 9.

¹ See [IASB 'IAS 28 Amendment' Project page](#) for further details.

² In addition to equity instruments, instruments with potential voting rights that in substance currently give access to the returns associated with an ownership interest in an associate or a joint venture (or in a subsidiary) are specifically scoped out of IFRS 9 and are instead accounted for in accordance with IAS 28 (or IAS 27). See IAS 28: 14 and IFRS 10: B91. We note that because such instruments are exposed to equity-like returns, then even if they were within the scope of IFRS 9, they would be required to be classified at Fair Value through Profit or Loss.

3.2. Undocumented loans

Special consideration should be given to loans that are undocumented (i.e. loans that are advanced without any contractual terms such as a specified repayment date or interest rate). In these cases, entities must first determine whether the arrangement gives rise to a debt instrument or, in accordance with the laws and regulations in their jurisdiction, a capital contribution. As noted in Section 3.1. above, this is an important distinction because if the loan is considered to be a debt instrument it will fall within the scope of IFRS 9, whereas if it gives rise to a capital contribution and is considered part of the equity investment it will fall within the scope of IAS 27 or IAS 28.

If an entity provides funding without any contractual terms it is typically treated from a legal perspective as a repayable on demand loan and not a capital contribution. This means that under the applicable laws and regulations, the lender has a substantive right to demand repayment; the fact that the lender may choose not to demand repayment for some time does not negate this right. Consequently, this type of arrangement typically gives rise to a debt instrument within the scope of IFRS 9.

However, in some jurisdictions, it is possible that the effect of applicable laws and regulations means that an undocumented funding arrangement could be considered to be a capital contribution (i.e. part of the equity investment). In those cases, the entity would apply IAS 27 or IAS 28, and not IFRS 9. This is not expected to be common and entities would be expected to provide detailed and robust evidence to support any such assertion, which may include appropriate legal advice. A careful analysis of undocumented funding arrangements will therefore be required. This could be particularly important for entities with multinational operations as their related company funding arrangements will be governed by multiple different legal jurisdictions.

BDO comment – Amendments to related company funding arrangements

Entities wishing to amend existing funding arrangements should carefully consider whether those changes alter the nature of the arrangement e.g. a debt instrument being converted to a capital contribution or the terms of a debt instrument being modified.

Amendments that reflect the existing arrangement – Parent A has an undocumented funding arrangement with Subsidiary B that is currently accounted for as an interest-free demand loan, reflecting its nature and consistent with local law. If Parent A decides to formally document this arrangement as an interest-free demand loan such that there is no change to its nature, then no accounting consequences should arise.

Amendments that alter the existing arrangement – Parent A has a funding arrangement with Subsidiary B that is currently accounted for as an interest-free demand loan, reflecting its nature and consistent with its contractually documented terms (or, if undocumented, consistent with local law). If Parent A amends this arrangement by removing the obligation to repay the amount advanced, there will be accounting consequences for both parties because the nature of the arrangement has changed – in this example, Parent A derecognises the loan receivable and recognises an addition to its investment in Subsidiary B and Subsidiary B extinguishes the loan payable and recognises a capital contribution. This might also have related tax effects and/or company law implications such as distributable profits. In contrast, if the new arrangement continues to contain a repayment obligation but the terms are now modified e.g. new interest rate or maturity date, the relevant modification requirements in IFRS 9 and associated accounting consequences should be considered by both parties.

4. CLASSIFICATION AND MEASUREMENT OF RELATED COMPANY LOAN RECEIVABLES

For further information on the classification and measurement requirements of IFRS 9, please refer to 'IFRS in Practice: IFRS 9 Financial Instruments' which is available on the [BDO Global IFRS webpage](#).

Once it has been determined that the loan receivable is within the scope of IFRS 9, it must be classified into one of three categories:

- a) Amortised cost;
- b) Fair Value through Profit or Loss (FVPL); or
- c) Fair Value through Other Comprehensive Income (FVOCI) for debt.

The classification category determines the measurement requirements including whether the Expected Credit Loss (ECL) model applies. Classification is based on two key criteria³:

- The business model in which the loan is held (i.e. is it held in a 'hold to collect', 'hold to collect and sell' or 'other' business model); and
- The contractual cash flows of the loan (i.e. do they represent Solely Payments of Principal and Interest – commonly referred to as the 'SPPI test').

The table below illustrates the interaction between the business model and contractual cash flow criteria for loans:

BUSINESS MODEL		Hold to collect	Hold to collect and sell	Other
CASH FLOW TYPE	SPPI	Amortised cost	FVOCI	FVPL
	Other	FVPL	FVPL	FVPL

Related company loans that are classified at amortised cost or at FVOCI (for debt) are subject to the ECL model, whereas those classified at FVPL are not.

While many related company loans will meet the criteria to be classified at amortised cost i.e. in a 'hold to collect' business model with cash flows that meet the SPPI test, entities should not assume this to be the case. A number of potential issues require consideration, in particular in relation to the SPPI test.

BDO comment – Purchased or Originated Credit Impaired

In addition to assessing the business model in which the loan is held and whether the loan meets the SPPI test, another relevant consideration is whether or not the loan is credit impaired at the point at which it was purchased or originated, i.e. at initial recognition (IAS 39: AG5 contained a similar requirement).

If a loan meets the definition of a Purchased or Originated Credit Impaired (POCI) financial asset, it will be subject to special requirements for recognising interest income and for recognising ECL.

Appendix A considers this requirement in the context of related company loans and contains a brief summary of the accounting requirements. Related company loans that meet the POCI definition are not expected to be particularly common and therefore the examples that follow assume that the loans are not POCI.

³ Subject to availing of the option to designate a loan at FVPL in cases of an accounting mismatch in accordance with IFRS 9: 4.1.5.

4.1. Business Model

A business model refers to how an entity manages its financial assets in order to generate cash flows and is determined at a level that reflects how groups of financial assets are managed (rather than on an instrument-by-instrument basis). IFRS 9 identifies three types of business models: 'hold to collect', 'hold to collect and sell' and 'other'. Examples of 'other' business models include held for sale, held for trading or managed on a fair value basis⁴.

Most related company loans will be held with the objective of collecting their contractual cash flows i.e. in a 'hold to collect' business model and consequently will be classified at amortised cost provided the SPPI test is met.

In the more unusual circumstances where a related company loan is held in a 'hold to collect and sell' or 'other' business model it will not be possible to classify the loan at amortised cost irrespective of whether the SPPI test is met.

4.2. Solely Payments of Principal and Interest

The aim of the SPPI test is to identify financial assets with contractual cash flows that are consistent with a basic lending arrangement i.e. payments of principal and interest on the principal amount outstanding. The principal amount is defined as being the fair value of the financial asset at initial recognition and interest is defined narrowly as being compensation for the time value of money and credit risk (although consideration for other lending risks such as liquidity risk, administrative costs and a profit margin can be included). This means that any cash flows that are linked to other risks such as commodities or equities will fail the SPPI test. Any related company loans that do not meet the SPPI test must be classified at FVPL irrespective of the business model in which they are held⁵.

In many cases, it will be clear that the contractual terms of the loan specify payments of principal and interest but this is not always the case. For example, some related company loans are interest-free and others may contain contingent or non-recourse features that require further analysis.

4.2.1. Interest-free loans

Interest-free loans can be contractually repayable at a specific maturity date (term loans) or at any point in time (demand loans). Other loans may not have a contractually specified repayment date but are considered due on demand from a legal perspective (see Section 3.2.).

Example 1 – Interest-free term loan

Parent A obtains external bank financing at competitive market rates and then lends to its subsidiaries on an interest-free basis. On 1 January 2018, Parent A advanced a loan of CU1 million to Subsidiary B with the following terms:

- CU1 million repayable in three years – December 2020;
- 0% interest.

The purpose of the loan is to fund Subsidiary B's ongoing business operations and, based on current cash flow projections, Subsidiary B is expected to be in a position to fund the repayment of the loan by December 2020. Assume that:

- The market rate of interest for a loan with similar terms is 15%; and
- The loan not considered POCL.

Question: Does the loan meet the SPPI test?

⁴ IFRS 9: 4.1.1. - 4.1.4. and B4.1.1.- B4.1.6.

⁵ IFRS 9: 4.1.1. - 4.1.4. and B4.1.7. - B4.1.26.

Analysis

In order to meet the SPPI test, the contractual cash flow of CU1 million in three years must represent payments of principal (being the initial fair value) and interest (being interest accrued using the EIR method).

The initial fair value will be the amount recognised in accordance with IFRS 9 at initial recognition that is generally equal to the transaction price. However, in the case of long-term interest-free loans, the standard contains guidance that is more specific. In such scenarios, the initial fair value is measured as the present value of future cash receipts discounted at an appropriate market rate of interest for a similar loan at the date of initial recognition⁶.

In this example, the present value CU1 million in three years discounted by the market rate of interest of 15% is CU658,000. This amount will accrete back to CU1 million over the 3-year life of the loan using the EIR method at a rate of 15%. In this way, the contractual cash flow of CU1 million due in 2020 represents payments of principal (being the initial fair value of CU658,000) and interest (being the accretions of CU342,000). The loan therefore meets the SPPI test.

The difference between the initial fair value of CU658,000 and the amount of cash advanced of CU1 million (i.e. CU342,000) will be considered a capital contribution and an addition to Parent A's investment in the Subsidiary B. This amount will not be within the scope of IFRS 9. Instead, it will be accounted for in accordance with IAS 27 and subject to impairment testing in accordance with the requirements of that standard (i.e. IAS 36 *Impairment of Assets*).

BDO comment – Prepayment options

If, in Example 1 above, Subsidiary B had an option to repay the loan at par at any time, entities would need to consider whether that prepayment option was consistent with the SPPI test. The general rule set out in IFRS 9: B4.1.11.(b) is that a prepayment option is only consistent with the SPPI test as long as the prepayment amount represents substantially all the unpaid amounts of principal and interest on the principal amount outstanding (which may include additional reasonable compensation). Applying these requirements to the example above would result in the loan failing the SPPI test because the prepayment amount of par would be greater than the principal (i.e. the fair value at initial recognition) and interest outstanding (i.e. interest accrual using the EIR method).

However, IFRS 9: B4.1.12. contains an exception to this requirement for loans that are originated (or purchased) at a discount (or premium) that would otherwise meet the SPPI test. In those cases, if the prepayment amount is equal to the contractual par amount plus the contractual (accrued but unpaid) interest amount (which may include additional reasonable compensation) and if the fair value of the prepayment option at initial recognition is insignificant, then the loan can still meet the SPPI test.

In the context of the example above, this exception is likely to apply because:

- (i) The loan is originated at a discount;*
- (ii) The prepayment option is at par; and*
- (iii) The fair value of the prepayment option at initial recognition would be insignificant (because Subsidiary B would be unlikely to repay given the preferential interest rate of 0%).*

⁶ IFRS 9: 5.1.1. and B5.1.1.

Example 2 – Interest-free demand loan

Parent A provides a loan of CU5 million to Subsidiary C to fund its ongoing business operations. The loan has the following terms:

- 0% interest;
- CU5 million repayable on demand of Parent A.

Assume that:

- Parent A does not intend to demand repayment of the loan for several years; and
- The loan is not considered POCL.

Question: Does the loan meet the SPPI test?

Analysis

Similar to the previous example, in order to meet the SPPI test, the contractual cash flow of CU5 million repayable on demand must represent payments of principal (being the initial fair value) and interest (being interest accrued using the EIR method).

The initial fair value will be the amount recognised in accordance with IFRS 9 at initial recognition which, in contrast to the previous example, is equal to the transaction price i.e. the amount of cash advanced of CU5 million. The fair value amount reflects the fact that Parent A has the contractual right to demand repayment immediately after the loan was advanced. In addition, unlike interest-free term loans, there is specific guidance in IFRS 9 which requires financial assets and liabilities to be measured on initial recognition at the transaction price (unless there is a difference between the transaction price and fair value, and the fair value is evidenced by a quoted price in an active market or is based on a valuation technique that uses only data from observable markets)⁷. As the loan is due on demand and no interest is charged, the EIR is 0%.

In this way the repayment of CU5 million represents the repayment of the principal amount (being the initial fair value) and interest (being nil as there are no interest accretions). The loan therefore meets the SPPI test.

As there is no difference between the initial fair value and the amount of cash advanced, no adjustment to Parent A's investment in Subsidiary C is required.

BDO comment – Subsequent measurement of interest-free loans classified at amortised cost (that are not POCL)

In Example 1, because an EIR of 15% is imputed for the interest-free term loan at initial recognition, the subsequent application of the EIR method results in the recognition of:

- *Interest income in profit or loss in accordance with IFRS 9: 5.4.1.; and*
- *Additional gains or losses in profit or loss which could arise as a result of applying, (where relevant) IFRS 9: B 5.4.6. For example, if the contractual cash flows are re-estimated as a result of changes in expectations of a prepayment or extension option being exercised.*

In contrast, in Example 2, because the EIR on the interest-free demand loan is 0%, the subsequent application of the EIR method will not give rise to interest income or other gains or losses in profit or loss as a result of applying IFRS 9: 5.4.1. or B5.4.6. respectively.

⁷ See IFRS 9: 5.1.1., 5.1.1.A and B5.1.1., B5.1.2.A. We note that Subsidiary C would also be required to recognise the corresponding demand liability at the transaction price in accordance with IFRS 13: 47.

4.2.2. Loans linked to underlying asset or borrower performance

Loans may also contain contingent features that give rise to cash flows that are inconsistent with the SPPI test.

Example 3 – Loan linked to underlying asset performance

Parent A provides a loan of CU3 million to Subsidiary D, a real estate investment company. Subsidiary D uses the loan to part fund a property worth CU3.5 million. Subsidiary D intends to generate cash flows through rental income. The loan has the following terms:

- CU3 million repayable in three years;
- 5% annual interest;
- 30% of the annual appreciation in the property value.

Question: Does the loan meet the SPPI test?

Analysis

Despite the fact that the loan has contractual payments of principal and interest, the additional contingent payment linked to the appreciation in the property value must be considered in order to determine whether the loan meets the SPPI test. This because IFRS 9 requires the loan to be assessed in its entirety i.e. as one unit of account and specifies that contractual terms can only be ignored if the potential impact on the contractual cash flows is considered 'de minimis' or if the feature is 'non-genuine'. When determining whether a contingent feature is 'de minimis' entities must consider the 'possible effect' that the feature **could** have on the contractual cash flows in each reporting period (and cumulatively). 'Non-genuine' contingent features are those that are only triggered upon the occurrence of a rare or highly abnormal event and are therefore not expected to be common⁸.

In this example, there is no reason to suggest that the contractual provision is non-genuine because a possible increase in property value above its purchase price would not be a rare or highly abnormal event. In addition, the contingent payment could have a more than de minimis effect on the contractual cash flows of the loan. For example, even an increase in value of 10% i.e. CU350,000 would give rise to an additional payment of CU105,000 (being CU350,000 x 30%) in the first year. The contingent feature therefore introduces property price risk, which is inconsistent with a basic lending arrangement⁹.

The loan fails the SPPI test and would be classified at FVPL¹⁰.

BDO comment – De minimis features that are genuine

*Because the de minimis analysis requires an entity to consider the 'possible effect' that the contingent feature **could have** on the contractual cash flows, the **likelihood** of the feature being triggered is **not relevant**.*

While de minimis is not defined IFRS 9, an example might be a contingent feature that, if triggered, could only ever have an immaterial effect on the contractual cash flows.

⁸ IFRS 9: B4.1.18.

⁹ IFRS 9: B4.1.15. - B4.1.16.

¹⁰ Similarly, a contingent payment linked to the profits of Subsidiary D would also fail the SPPI test as it introduces an equity-like risk.

4.2.3. Non-recourse loans

In most cases, loans are advanced on a full recourse basis, which means that if the borrower defaults, the lender has a general claim against the borrower for the full amount of the loan. For additional security, such loans are often collateralised which means that upon default, in addition to a general claim against the borrower, the lender has a first ranking charge over a specific asset or assets. The fact that a full recourse loan is collateralised should not generally affect the SPPI test.

However, in other cases, loans are advanced on a non-recourse basis which means that the lenders claim is limited to specified assets (or cash flows from specified assets) of the borrower. Non-recourse features will generally be part of the explicit contractual terms of the loan agreement but it is also possible for a loan to be implicitly non-recourse. For example, a full recourse loan, which may or may not be collateralised, that is advanced to a borrower that holds a single asset or limited assets, is in substance more akin to a non-recourse loan.

Non-recourse features do not, by themselves, preclude a financial asset from meeting the SPPI test but additional analysis is required in order to determine whether the loan is:

- A lending exposure for which the lender receives payments of principal and interest (being compensation for credit risk and the time value of money) that meets the SPPI test; or
- An indirect investment in the underlying assets of the entity for which the lender will receive payments dependent upon the performance of specific assets that fails the SPPI test.

When a non-recourse feature is present, the lender is required to look-through to the underlying assets (which can be financial or non-financial in nature) or cash flows and determine whether the contractual terms of the loan give rise to cash flows that are inconsistent with SPPI or limit the cash flows in a manner that is inconsistent with SPPI¹¹.

Example 4(a) – Non-recourse loan – Scenario 1

Parent A set up Subsidiary E in January 2017 for the purposes of purchasing a single investment property worth CU2 million with the aim of generating rental income. Subsidiary E was funded via CU200,000 of equity from Parent A and a loan at 90% loan-to-value (LTV) from Bank X with the following terms:

- CU1.8 million repayable on 31 December 2018, annual interest rate of 10%;
- Secured by first charge over the property.

At 31 December 2018, the market valuation of the property has declined to CU1.5 million, resulting in a LTV of 120% (CU1.8 million/CU1.5 million). Bank X is unwilling to refinance at this LTV and as a result, Subsidiary E repays the bank loan and obtains financing from Parent A with the following terms:

- CU1.8 million repayable on 31 December 2020, annual interest rate of 20%;
- Secured by first charge over the property.

Assume that:

- Subsidiary E continues to earn rental income sufficient to cover interest payments but has no other assets or sources of income; and
- 20% is considered to be a market rate of interest for a loan with similar terms (loans with similar terms are available through specialist property lenders. Such lenders are willing to advance loans at greater than 100% LTV based on the potential for property prices to increase to a level that would result in full recovery of the loan).

Question: Does the loan from Parent A to Subsidiary E meet the SPPI test?

¹¹ IFRS 9: B4.1.16. - B4.1.17.

Analysis

Irrespective of whether the loan is structured on a full recourse basis, the substance is that of a non-recourse loan because Subsidiary E only holds one asset that can be used to repay the loan. Subsidiary E is expected to be in a position to meet its interest payment obligations using its rental income. However, at an LTV of 120%, the principal repayment is limited in a manner that appears inconsistent with a basic lending arrangement, as the value of the property to which it has recourse is not sufficient to repay the loan.

The property price risk that Parent A is exposed to would seem to imply that the loan is more in the nature of an indirect investment in the underlying property rather than an exposure to basic lending risks i.e. the time value of money and credit risk.

On this basis, the loan would fail the SPPI test and would be classified at FVPL.

Example 4(b) – Non-recourse loan – Scenario 2

Same facts as Example 4(a) except that on 31 December 2018, the market valuation of the property has increased by CU200,000 to CU2.2 million resulting in a LTV of 82% (CU1.8 / CU2.2). Bank X is prepared to refinance the loan at market rates but Subsidiary E chooses to repay the bank loan and obtain funding from Parent A on the following terms:

- CU1.8 million repayable on 31 December 2020;
- Interest rate of 7%.

Assume that 7% is considered to be a market rate of interest for a loan with similar terms.

Question: Does the loan meet the SPPI test?

Analysis

Similar to the previous example, the substance of the loan is limited recourse because Subsidiary E only holds one asset that can be used to repay the loan. However, in contrast to the previous example, based on the current LTV of 82% the principal repayment would not seem to be limited in a manner that is inconsistent with a basic lending arrangement because the value of the property is more than sufficient to generate cash flows to repay the loan.

The loan is likely to meet the SPPI test.

BDO comment – Distinguishing between credit risk and asset performance risk

Determining whether a non-recourse loan meets the SPPI test can be a very judgmental area because the distinction between an entity's credit risk and asset performance risk is not always clear. This is particularly true in cases where an entity is funded almost entirely by debt and has a single or very limited number of assets. A careful assessment of all relevant facts and circumstances will therefore be required. Examples of factors that that would indicate an exposure to credit risk (i.e. meeting the SPPI test) rather than asset performance risk include:

- A loan to value ratio which demonstrates that the fair value of the underlying asset(s) to which the borrower has recourse (whether these are only specified assets or all assets of the borrower) are more than sufficient to support the contractual repayment of amounts of principal and interest on the loan;
- The nature of the borrower being that of an operating entity with commercial substance that may be able to source alternative funding;
- Sufficient levels of equity in the borrower entity to cover any expected losses; and
- The loan being managed by the lender as an exposure to credit risk.

One of the areas where this assessment may prove particularly challenging is in cases where the borrower is not only thinly capitalised but is also engaged in early stage high-risk projects such as R&D or mining exploration. Despite typically being supported by a robust business plan, the high risk nature of such projects often means that there is no viable alternative source of finance other than through related companies.

While such cases will require increased levels of scrutiny and judgment, it is important to note that the fact that the borrower's business is high risk does not, in and of itself, mean that the loan will automatically fail the SPPI test. If that were the case, then all Purchased or Originated Credit Impaired (POCI) loans would fail the SPPI test and would therefore be measured at FVPL rendering the POCI requirements redundant. Furthermore, as explained in Appendix A, the fact that a loan has high credit risk at origination does not mean that it meets the definition of a POCI loan.

In these situations, as explained in Section 4.2.3, entities will need to exercise their judgment in order to determine whether the loan is:

- A credit exposure i.e. the provision of funding for which the lender receives payments of principal and interest; or
- An exposure to the underlying assets - i.e. an indirect investment in the underlying assets of the borrower.

For example, consider a parent company advancing a loan to a subsidiary which has commercial substance and is using its resources to actively manage and develop an underlying project. In this scenario, assuming the subsidiary is not insolvent at the date the loan is advanced, it is likely that the parent company will be managing that loan as an exposure to credit risk rather than an exposure to the underlying assets of the subsidiary.

5. IMPAIRMENT OF RELATED COMPANY LOAN RECEIVABLES

For further information on the impairment requirements of IFRS 9, please refer to 'IFRS in Practice: IFRS 9 Financial Instruments' which is available on the [BDO Global IFRS webpage](#).

IFRS 9 replaces the existing backward-looking (incurred loss) impairment model in IAS 39 with a forward-looking Expected Credit Loss (ECL) model. This will result in the earlier recognition of credit losses because it will no longer be appropriate to wait for evidence of an incurred loss event before recognising a provision. The incorporation of relevant forward-looking information is therefore central to the ECL model.

Credit losses are calculated as the present value of the difference between the contractual and expected cash flows (i.e. the cash shortfalls) and ECL represent the weighted average of those credit losses based on the respective risks of a default occurring.

There are three different approaches to applying the ECL model; the General Approach, the Simplified Approach and the Purchased or Originated Credit Impaired (POCI) approach. Related company loans that are not POCI and that are classified at amortised cost (or at FVOCI for debt) are subject to the General Approach and are not eligible for the Simplified Approach, irrespective of their maturity.

5.1. General Approach

Under the General Approach, at each reporting date, entities are required to determine whether there has been a Significant Increase in Credit Risk (SICR) since initial recognition and whether the loan is credit impaired¹². This determines whether the loan is in **Stage 1**, **Stage 2** or **Stage 3**, which in turn determines both:

- The amount of ECL to be recognised: 12-month ECL or Lifetime ECL; and
- The amount of interest income to be recognised in future reporting periods: EIR based on gross carrying amount of the loan which excludes ECL or the net carrying amount (i.e. the amortised cost) which includes ECL.

Lifetime ECL are the ECL that result from all possible default events over the expected life of the loan whereas 12-month ECL are a portion of Lifetime ECL that represent the ECL that result from default events that are possible within 12 months of the reporting date. For loans with an expected life in excess of 12 months, Lifetime ECL will typically be greater than 12-month ECL because entities will need to factor in all possible default event rather than only those possible within 12 months.

It is important to note that the ECL model is symmetrical in nature, which means that a loan can move between the various stages. For example, a previous SICR can reverse such that a loan transfers from **Stage 2** back to **Stage 1**.

The interaction between the different stages and the amount of ECL and interest income to be recognised is set out in the table below:

	Stage 1 No SICR	Stage 2 SICR	Stage 3 Credit Impaired
Recognition of ECL	12-month ECL	Lifetime ECL	
Recognition of interest	EIR on gross carrying amount (excluding ECL)		EIR on net carrying amount (including ECL)

Sections 5.2. - 5.5. below outline the key requirements of the ECL model, focusing specifically on how they are applied to related company loans. Section 5.6. contains two worked examples illustrating how the ECL requirements could be applied in practice for an interest-free term loan and an interest-free demand loan.

¹² IFRS 9: 5.5.1.- 5.5.5., IFRS 9: 5.4.1.(b).

5.2. Reasonable and Supportable Information

The incorporation of reasonable and supportable information is central to applying the ECL model. Because of this, we discuss what is meant by reasonable and supportable information on a more general level in this section before exploring how it should be incorporated into other areas of the ECL model.

The standard requires that reasonable and supportable information that is available without undue cost or effort about past events, current conditions and forecasts of future economic conditions must be incorporated when assessing for SICR and when measuring ECL¹³.

For most entities, historic information will be the most relevant starting point but this will typically need to be adjusted in order to reflect current conditions and future forecasts. For example, historic information gathered over a period of economic stability (or over a period of economic recession), may not be reflective of current or future expectations. Similarly, the past performance of a borrower may not be indicative of its future performance. The incorporation of relevant information, in particular forward looking information, is likely to require considerable judgment and additional work.

BDO comment – Undue cost or effort

While there is no expectation that an entity should undertake an exhaustive search for information, the inclusion of 'without undue cost or effort' does not mean no cost or effort. Entities are therefore expected to obtain appropriate and sufficient forward-looking information, including, if necessary, from external sources for which there may be a charge from the provider.

Types of information

The information considered must include both borrower specific information as well as information about the economic and business environment in which the borrower operates. Borrower specific information could include information about key performance indicators that have an effect on the borrower's ability to meet its obligations such as operating profit, gearing and liquidity. In addition, when estimating expected cash flows in different recovery scenarios, information about the value of collateral, asset quality and the value of the underlying business will be relevant. Information about the wider economic and business environment should include information about relevant economic factors such as economic growth, unemployment, commodity prices or the competitive environment as well as economic events such as the impact of Brexit.

Only information that affects the credit risk of the borrower and/or the measurement of ECL is considered. Entities therefore need to understand the drivers of credit risk and ECL and focus on information relevant to these drivers. For example, if a borrower operates in the copper mining industry, changes in the price of copper are likely to be a key driver whereas levels of unemployment might be a key driver for entities operating in the retail sector.

¹³ IFRS 9: 5.5.17., B5.5.49. - B5.5.54.

Sources of information

To some extent, the entity's own experience should be a useful source of historical and current information relating to default rates and credit losses. However, if sufficient information is not available internally, entities may need to source information externally, for example considering information about similar exposures to entities in the same sector. This may involve obtaining information from external providers such as credit bureaux.

Obtaining forward-looking information, in particular macro-economic information may be more challenging. While some level of forward-looking information may be available internally, for example as part of the entities budgeting and forecasting processes, this may not be sufficient. Therefore, using external data sources such as industry reports and economic outlooks are likely to be necessary.

BDO comment – Suitability of external information

Entities should carefully consider the suitability of any external information used and make relevant adjustments where needed. For example, if an entity obtains external information about default rates but that information relates to entities with a higher credit rating or exposures that are more senior in nature than the exposure being considered, then using these unadjusted default rates would not be appropriate. In addition, any historical information would need to be adjusted to reflect forward-looking information.

Consistency of information

Because both the SICR assessment and the measurement of ECL must incorporate reasonable and supportable information, entities need to consider the consistency of information used. For example, if the assessment of SICR on a particular loan assumed a stable future economic environment whereas estimates of ECL for that loan incorporated a more positive future economic environment, then this inconsistency would need to be either removed or explained. An example of an explainable difference might be the value of collateral because this does not generally affect the SICR assessment but will typically impact ECL measurement (see Section 5.5.2.(b)(ii)). Entities should also consider whether the information used is consistent with other forward-looking information, which may be used for budgeting and forecasting purposes.

Number of scenarios considered

At a minimum, entities are required to consider the possibility of a credit loss and the possibility of no credit loss. However, in some cases, in order to calculate a probability weighted measure of credit losses entities will need to consider a range of different future scenarios¹⁴. This is because additional credit losses (or increases in credit risk) that arise in a downside scenario will often be greater than the reduced losses (or reduced credit risk) in the equivalent upside scenario. In these cases, using only the most likely future scenario will not be sufficient because the relationship between the different scenarios and corresponding credit losses (or credit risk) is non-linear. Additional scenarios will therefore need to be considered in order to capture this effect. An example of when this might arise is discussed in Section 5.5.1.(c).

¹⁴ IFRS 9: 5.5.17. - 5.5.18., B5.5.41.- B5.5.43.

BDO comment – Internal information may not be sufficient

In the context of loans to related companies, entities are likely to have a significant amount of borrower specific information available to them internally. For example, a parent company will typically have full access to its subsidiaries business performance, cash flow projections, budgets and forecasts.

While this information is already likely to incorporate some degree of general economic information as part of any entity's normal budgeting and forecasting processes, it should not be assumed that this is sufficient to meet the requirements of IFRS 9. For example, the information may not be sufficiently forward-looking or may be based on the most likely outcome instead of considering a range of possible outcomes.

5.3. Significant Increase in Credit Risk (SICR)

At each reporting date, the credit risk of each loan needs to be assessed in order to determine whether there has been Significant Increase in Credit Risk (SICR) since initial recognition.

This assessment is crucial because it determines whether a loan should be in **Stage 1**, with 12-month ECL being recognised, or **Stage 2**, with Lifetime ECL being recognised. There are a number of key requirements and factors to consider which are discussed further below.

BDO comment – Assessing for SICR

The SICR assessment is a new concept introduced by IFRS 9 and the standard does not specify a particular method of making the assessment or provide a specified threshold (or 'bright line') for what constitutes a 'significant' increase. Applying these requirements is therefore likely to be a challenging and judgmental area for many entities, in particular for entities that are not in the business of lending. For example, corporates often advance loans to related companies on terms that are not arms-length and may not have formal credit monitoring processes in place.

When assessing for SICR, the focus is on the 'risk of a default occurring'. Many banking entities are already required to measure this risk regulatory purposes using a 'probability of default (PD)' measure and are therefore likely to use changes in those PDs as a starting point for the SICR assessment. However, while IFRS 9 uses PDs in a number of Illustrative Examples, this is only one method of measuring the risk of a default occurring and there is no requirement to use this particular method. This point was specifically clarified by the IASB during its deliberations and as a result the final standard refers to the risk of a default occurring rather than the probability of a default occurring [see IFRS 9: BC5.156 - BC5.157].

Most corporate entities will not have sophisticated credit risk measures such as PDs available and are unlikely to be in a position to develop such statistical models without undue cost or effort. As such, the SICR assessment may need to be qualitative in nature. For example, in the context of loans to related companies, entities are likely to have considerable amounts of borrower-specific information available internally including key business/economic risks, key performance indicators, performance against budgets/forecasts and past due information. As part of how any entity manages its risks, this information should already be subject to some degree of monitoring which, when developed and coupled with external information where necessary should, in many cases, be sufficient to allow a qualitative SICR assessment.

However, while such an approach will limit the quantitative complexity of tracking an explicit risk of default measure over the life of the loan, entities should remember that the measurement of ECL would still require some quantification of the risk of a default occurring over the next 12 months or the remaining life of the loan at each reporting date.

Ultimately, entities will need to make their own judgment as to which approach they should use taking into account how sophisticated the entity is, the internal and external information available and the characteristics of its financial instruments. The approach used should, however, reflect the principles underlying the SICR assessment, be sufficiently documented, subject to regular review and applied consistently for similar loans. Entities should also be aware that IFRS 7 requires entities to disclose how an entity assesses for SICR together with the inputs, assumptions and estimation techniques used.

5.3.1. Key Requirements for the SICR assessment

IFRS 9 requires that any approach used to make the SICR assessment should¹⁵:

- a) Compare the credit risk at the reporting date to the credit risk at initial recognition i.e. the assessment is relative;
- b) Focus on changes in the risk of default (not the risk of loss) over the expected life of the loan; and
- c) Incorporate reasonable and supportable information, including forward looking information that is available without undue cost or effort.

a) Relative Assessment

The SICR assessment is based on a comparison of the credit risk at initial recognition to the credit risk at the reporting date. This means that entities will be required to assess the credit risk of their related company loans at initial recognition and at each subsequent reporting date.

One of the consequences of the relative nature of the assessment is that loans advanced to the same counterparty with the same credit risk at the reporting date could be in different stages of the ECL model depending on their respective credit risks at initial recognition¹⁶.

Example 5 – Relative assessment

Parent A provides loans on a regular basis to its subsidiaries.

On 1 January 2017, Parent A advanced a CU1 million loan (Loan A) to Subsidiary F and assessed that the credit risk was 'low' at that date.

On 1 January 2018, Parent A advanced another CU1 million loan (Loan B) to the same subsidiary. At this date, Parent A assessed that the credit risk was 'high' due to an unexpected downturn in economic and business condition which has negatively impacted the credit standing of Subsidiary F.

At the 31 December 2018, Parent A assesses that credit risk on both loans is 'very high'.

Question: Is it appropriate for Parent A to conclude that both loans have suffered a SICR?

Analysis

Not necessarily. While both loans have experienced an absolute increase in credit risk and now share the same credit risk, the fact that Loan A has suffered a greater relative increase in credit risk than Loan B is important. Based on the facts presented, Loan A has moved from an initial 'low' credit risk to a 'very high' credit risk and a relative movement of this magnitude would constitute a SICR. However, Loan B has only moved from a 'high' to 'very high' credit risk, meaning that its relative increase in credit risk is smaller than Loan A and may not necessarily constitute a SICR. However, Parent A must still perform a further assessment on Loan B in order to determine whether this relative movement from a 'high' to 'very high' credit risk constitutes a SICR.

If Parent A were to make the SICR assessment based on an absolute level of credit risk at the reporting date, for example, if all loans with a 'very high' credit risk were considered to have suffered a SICR, this would not appropriately capture the **relative** changes in credit risk and could lead to an incorrect SICR assessment.

¹⁵ IFRS 9: 5.5.9.

¹⁶ IFRS 9: B5.5.9.

BDO comment – Importance of the relative assessment

The relative nature of the SICR assessment is consistent with the underlying objective of the ECL model which is to recognise lifetime ECL **for all loans that have suffered a SICR since initial recognition** i.e. the aim is not to recognise lifetime ECL for all loans with a high absolute level of credit risk. This is because in most third party scenarios, if a loan has a high credit risk at initial recognition, this will be reflected through an appropriate market rate of interest being charged over the term of the loan.

While related company term loans are often interest-free, the market rate of interest that would have been charged by an unrelated third party will still be reflected in the financial statements. For example, consider a parent that lends to a subsidiary for 5 years on an interest-free basis. The difference between the amount of cash advanced and the present value of that amount in 5 years discounted by the market rate of interest that would have been charged by an unrelated third party will be added to the entity's investment in its subsidiary and accounted for as a capital contribution in the subsidiary.

When assessing for SICR, entities need to strike a balance between an assessment that adequately captures relative changes in credit risk but does not result in loans moving frequently between **Stage 1** and **Stage 2** as a result of changes in credit risk that are not significant. Entities need to use their judgment in determining both how they will monitor changes in credit risk and what they consider to be acceptable tolerance levels which may require a combination of both relative and absolute assessments. For example, an entity may assess for SICR by reference to a relative deterioration in key performance indicators and ratios since initial recognition subject to a number of acceptable tolerance levels (some of which may be absolute in nature). However, this would **only be acceptable if** the entity can demonstrate that a deterioration in those key performance indicators and ratios within those tolerance levels **do not constitute a SICR**.

b) Risk of default (not loss) over the expected life

Credit risk in the context of the ECL model specifically relates to the **risk of a default** occurring (**not the risk of loss** occurring) and this must be assessed over the **expected life** of the loan. This requirement has some important implications as discussed below.

(i) Defining default

The standard does not define default but does point out that qualitative factors, as well as payment defaults, must be considered. Qualitative factors that an entity could consider when defining default could include breaches of covenant, financial difficulty and/or liquidity issues of the borrower.

BDO comment – Factors to consider when defining default

The fact that default needs to be defined more widely than just payment default is important. It means that it would not be appropriate to conclude that there is no risk of default over a particular period simply because no payments were due during that period. This is because other events that could ultimately cause payment defaults in the future could occur during that payment-free period.

When identifying relevant qualitative factors for the purposes of defining default, the indicators of a credit impaired financial asset set out in Appendix A of IFRS 9 may be helpful. For example, financial difficulty of the borrower is one of the indicators of a financial asset being credit impaired and this might also be a reasonable indicator of default. The risk of a default occurring could therefore include an assessment of the likelihood of the borrower being in financial difficulty and changes in likelihood of this event occurring could also be relevant for the purposes of SICR. Key financial ratios could be useful in making this determination.

There is also a rebuttable presumption that a default has occurred if payments are more than 90 days past due, but this is a backstop indicator only and should not delay the point at which an entity considers a default to have occurred¹⁷.

BDO comment – Use of the 90 days past due rebuttable presumption

The fact that the 90 days past due rebuttable presumption can only be used as a backstop is consistent with the requirement to define default more widely than payment defaults. Relying on this presumption to define default would not be appropriate for related company loans that are advanced on an interest-free basis. For example, in the case of an interest-free term loan repayable in 5 years, it would not be appropriate for the lender to define default simply by reference to the number of days past due. This is because there is only one payment obligation at maturity and this cannot mean that there is no risk of default until the payment falls due. Similarly, in the case of an interest-free demand loan, it would not be appropriate to define default in this way because assuming repayment has not been demanded at the reporting date, past due information will not be available. In these cases, entities will need to consider other more qualitative factors when defining default.

(ii) Amount of loss is not relevant

It is common for loans to benefit from different forms of credit enhancement such as collateral or guarantees that protect the lender from losses incurred in the event of a borrower default. Cash flows arising from such credit enhancements are generally included when measuring ECL as long as they are integral to the contractual terms and not accounted for separately (see Section 5.5.2.).

However, because the SICR assessment focuses on the risk of default rather than the risk of loss, credit enhancements are generally excluded when assessing for SICR because they will not have an effect on the borrower's credit risk i.e. risk of default¹⁸.

Example 6 – Credit enhancements – Guarantees

Parent A has two subsidiaries, Subsidiary G and Subsidiary H.

Subsidiary G lends CU1 million to Subsidiary H. The loan benefits from a guarantee issued by Parent A, which will reimburse Subsidiary G for any losses it incurs on the loan. Assume that:

- The guarantee meets the IFRS 9 definition of a financial guarantee contract (FGC); and
- The loan meets the criteria to be classified at amortised cost.

Question: Should Subsidiary G consider the financial guarantee when assessing for SICR?

Analysis

No. In this example, the guarantee should be ignored by Subsidiary G when assessing for SICR because while it will compensate for losses incurred, it will not prevent Subsidiary H from defaulting on the loan in the first instance.

In contrast, if Parent A provided a different type of guarantee, the nature of which could prevent Subsidiary H from defaulting e.g. if the terms of the guarantee required Parent A to inject equity into Subsidiary H, the analysis would be different. This is because, in that scenario, the guarantee could prevent Subsidiary H from defaulting and therefore the quality of that guarantee and the financial strength of Parent A should be taken into account by Subsidiary G when assessing for SICR¹⁹.

¹⁷ IFRS 9: B5.5.36. - B5.5.37.

¹⁸ IFRS 9: B5.5.12.

¹⁹ IFRS 9: B5.5.17.(k).

BDO comment – Cross company guarantee structures

Many corporates have cross company guarantee structures in place and these will need to be analysed in order to determine how they interact with the new ECL requirements from the perspective of both the guarantee holder and the guarantee issuer.

*From the perspective of the **holder**, the nature of the guarantee will determine whether it can be included in the SICR assessment (as discussed in Section 5.3.1.(b)(ii) above) and if not, whether it can be included in the measurement of ECL (see Section 5.5.2.).*

*From the perspective of the **issuer**, if the guarantee meets the definition of a financial guarantee contract (FGC), then it is likely to be within the scope of the ECL model itself. Appendix B contains a brief summary of how the new ECL model will change the accounting for certain issued FGCs. A detailed analysis of how the ECL model is applied to issued FGCs is outside the scope of this publication.*

Example 7 – Credit enhancements – Collateral

Parent A has several subsidiaries operating in the professional services sector. Subsidiary K has an established consulting business and wishes to invest in a new office premises costing CU270,000 for its ongoing business operations.

Parent A lends CU200,000 to Subsidiary K on a full recourse basis in order to part fund this investment. The loan is repayable in 10 years and carries a market rate of interest. Under the terms of the loan, Parent A has first ranking security over the commercial premises, which at the reporting date is valued at CU300,000.

Assume the loan meets the criteria to be classified at amortised cost.

Question: Should Parent A take the collateral into account when assessing for SICR?

Analysis

No. In this example, the value of the collateral should not be considered by Parent A when assessing for SICR. This is because even though the value of the collateral is more than sufficient to cover the repayment of the loan and will serve to reimburse Parent A in the event of a default, it will not prevent Subsidiary K from defaulting in the first instance. Instead, the risk of default will depend on Subsidiary K's operating performance, financial strength and its ability to meet its payment obligations.

BDO comment – Relationship between collateral and credit risk

In some cases, assets that are pledged as security for a loan (i.e. collateral) can also affect an entity's credit risk.

For example, consider a subsidiary which was set up for the purposes of purchasing a single investment property worth CU1 million. The purpose of the entity was to manage the property and generate rental income. Assume that the parent company funded the subsidiary by injecting equity of CU200,000 and providing a loan of CU800,000 (i.e. 80% loan-to-value) which is repayable in 10 years. The loan carries a market rate of interest and is secured by a first charge over the property. Assume that the loan is held in a hold to collect business model, meets the SPPI test and is classified at amortised (see Example 4(b) for a further analysis on how to perform the SPPI analysis on a non-recourse loan).

In this example, the property, which also serves as collateral, is integral to the subsidiary's underlying property management business and is therefore directly linked to its operating performance, financial strength and its ability to meet its payment obligations. Consequently, the quality and value of the property does affect the subsidiary's credit risk (risk of default) because the cash flows generated from the property are the means through which principal and interest on the loan will be repaid in the normal course of business i.e. not just in the event of a default where the parent would enforce security. It is therefore appropriate to take the cash generating potential of the property into account when assessing for SICR. For example, the parent should consider whether the cash flows expected from rental income are sufficient to meet interest payment obligations over the 10-year term of the loan and whether at maturity, the property value is expected to be sufficient to either allow the subsidiary to refinance with another lender or sell the property and repay the loan. This is separate from, and in addition to, consideration of the value and potential for cash realisation of that collateral when measuring the amount of ECL.

In this case, and in contrast to Example 7 above, the asset that is pledged as security is also the primary cash generating asset of the subsidiary's business and therefore affects the risk of a default occurring.

(iii) Expected Life

The period over which the risk of a default is assessed is the expected life of the loan. Two important points relating to the expected life are addressed in the following sections.

Relationship with the risk of a default occurring

The risk of default usually reduces as the loan reaches maturity so this needs to be taken into account when assessing for SICR²⁰.

For example, consider an amortising loan originated on 1 January 2018 that has a 10 year expected life. After 4 years (i.e. at 31 December 2021), the lender assesses whether there has been a SICR. It first estimates the risk of a default occurring over the remaining 6 years and compares that to what it expected the 6-year risk of default would have been at initial recognition (i.e. not the original 10-year risk of default). Otherwise, the comparison could show a reduced risk of default that was simply down to the passage of time as opposed to an improvement in credit risk or alternatively, it could show an unchanged risk of default which might in fact imply that there has been a SICR.

The next example illustrates this principle using a simple scenario of an entity that uses changes in lifetime probabilities of default (PDs) to assess for SICR. The PD related terminology used in that example is explained below.

BDO comment – Calculating a lifetime PD

*The lifetime PD is the risk of a default occurring over the expected life of a financial asset and is calculated as the sum of the **marginal PDs** in each period. The marginal PD is conditional in nature because it is calculated on the assumption that the loan has not already defaulted in the previous period (i.e. it incorporates the survival rate).*

For example, consider a 2-year amortising loan. At initial recognition, assume the 12-month PD (i.e. the risk of a default occurring over the next 12 months) for year 1 is 10% and that this remains constant in year 2. In this example, the marginal PDs are calculated as follows:

- *The marginal PD in year 1 is 10% because this is the first period of assessment so it could not have defaulted in a previous period; whereas*
- *The marginal PD in year 2 is the second period of assessment and therefore must take into account that there is only a 90% chance that the loan will not have already defaulted in year 1 (i.e. a 90% survival rate). Therefore, the marginal PD in year 2 is 9% (i.e. 10% x 90%).*

This results in a lifetime PD of 19% (i.e. 10% + 9%).

Example 8 – Relationship between expected life and risk of a default occurring

Entity X advances a loan to Entity Y on 1 January 2019 with the following terms:

- 3-year maturity;
- Fully amortising;
- Market rate of interest.

Entity X assesses for SICR based on changes in PDs. At initial recognition, based on an analysis of historic default rates, Entity X estimates a 12-month PD of 10%. For the purposes of illustration, assume that:

- Forward looking information has been considered but no adjustments were required; and
- The 12-month PD is expected to be constant over the life of the loan.

In order to calculate the lifetime PD, Entity X first calculates the marginal PD (i.e. 12-month PD multiplied by the survival rate) for each period based on its credit risk assessment at initial recognition and then adds the marginal PDs in each year.

Period	12-month PD	Marginal PD	Lifetime PD
2019	10%	10%	27% [10% + 9% + 8%]
2020	10%	9% [10% x 90%]	17% [9% + 8%]
2021	10%	8% [10% x 81%]	8%

At 31 December 2019, the first reporting period following initial recognition, assume the lender revises its PD estimates for the remaining 2 years of the loan as follows:

Period	12-month PD	Marginal PD	Lifetime PD
2020	13%	13%	24% [13% + 11%]
2021	13%	11% [13% x 87%]	11%

Question: How should Entity X approach the SICR assessment at 31 December 2019?

Analysis

Entity X assesses for SICR by comparing the PD over the **remaining 2-year life at the reporting date** of 24% to the lifetime PD that it expected at that **2-year point at initial recognition** of 17%.

It would not be appropriate for Entity X to compare the original 3 year PD of 27% to the PD over the remaining 2-year life of 24% as this would not be a like for like comparison and would not give a true reflection of whether the credit risk has changed. This is because even if the 12-month PD estimates remained unchanged from initial recognition, i.e. at 10% in the example above, the lifetime PD would have been expected to reduce to 17% simply because of the passage of time.

However, for loans that have significant payment obligations concentrated close to maturity, IFRS 9 notes that the risk of default does not necessarily decrease as the loan reaches maturity and that in these cases other indicators of credit risk should be considered²¹.

²¹ IFRS 9: B5.5.11.

BDO comment – Loans with significant payment obligations at maturity

Many related company term loans are structured as interest-free with a bullet repayment of principal due at maturity. In these cases, it appears based on the guidance above that the lifetime risk of default may not necessarily decrease as maturity approaches.

However, while the lifetime risk of default may not decrease as quickly for such interest-free bullet loans, in general, it would still be expected to decrease over time. This is due to the fact that even though the risk of default is likely to be concentrated towards maturity, there will still be some risk of default to consider in the earlier years. This is because in accordance with IFRS 9, default must be defined more widely than payment defaults so even during the periods where no payments are due there is still a risk that a default might occur which would ultimately give rise to losses in a later period.

Despite the fact that corporates are unlikely to use changes in lifetime PDs to assess for SICR, entities should consider the relationship between the risk of a default occurring and the expected life as part of any qualitative SICR assessment and when estimating the appropriate 12-month or lifetime risk of a default for the purposes of ECL measurement.

Maximum period to consider

The expected life cannot be longer than the maximum period to consider when measuring ECL which is limited to the maximum contractual period, including extension options, over which the entity is exposed to credit risk (but can be shortened by prepayment expectations)²². However, only borrower extension options lengthen the period of exposure to credit risk because under a lender extension option, **the lender can choose not to extend**. This is the case even if the lenders past business practice and/or future expectations suggest that the extension option will be exercised.

BDO comment – Expected life and the maximum period to consider

The requirement to limit the expected life to the maximum contractual period of credit exposure has some important consequences interest-free related company loans which are contractually due on demand (or are undocumented but considered to be due on demand based on the local laws and regulations in that jurisdiction). In accordance with the requirement above, loans of this nature are considered to have an expected life of 'on demand' which affects both the period over which the risk of a default occurring is assessed as well as the staging assessment. These points are discussed in more detail below.

²² IFRS 9: 5.5.19.

BDO comment – Expected life and the maximum period to consider (continued)**Period over which the risk of a default occurring is assessed**

Because the expected life of a demand loan is 'on demand', the lender is required to assess the risk of a default occurring at initial recognition and at the reporting date assuming that repayment is demanded immediately (irrespective of the lenders intentions). This is likely to be a very binary analysis because the borrower will either have sufficient liquid assets to repay the loan immediately (meaning that the risk of default is very low) or it will not (meaning that the risk of default is very high).

For example, consider a parent company which advances an interest-free demand loan to its subsidiary. The subsidiary plans to use the funds over the next 6 months to invest in a high risk R&D project which is expected to take a number of years before it becomes cash generating. Consequently, the parent company does not intend to demand repayment of the loan until such time as the project is sufficiently developed to either allow the subsidiary to repay the loan or arrange for an alternative source finance. Assume that the loan meets the criteria to be classified at amortised cost and has an EIR of 0%.

At initial recognition of the loan, assuming the subsidiary had not yet invested the cash advanced, it would have sufficient funds to repay the loan on demand. This means that the risk of a default occurring assuming the parent demanded repayment immediately should be close to 0% at initial recognition. At the subsequent reporting date, assuming the subsidiary had invested the cash received but has no other source of finance because the project is still at an early stage, it would not have sufficient funds to repay the loan on demand. Even if the parent company has no intention of demanding repayment, the risk of default must be based on the assumption that repayment has been demanded which means that, in this example, the risk of default is likely to be close to 100%. In contrast, if at the reporting date, the subsidiary had not yet invested the cash, the risk of a default is likely to be close to 0%, similar to the analysis at initial recognition.

Staging assessment

In order to determine which stage the of the ECL model a demand loan is in, the lender is required to compare the risk of a default occurring over the expected life at initial recognition and compare that with the position at the reporting date. If there has been a significant increase in credit risk since initial recognition, the loan transfers to **Stage 2** and if the loan is credit impaired, the loan transfers to **Stage 3**. Continuing with the example above and assuming the subsidiary had invested the funds at the reporting date, this means that the parent company would compare the risk of a default occurring (of close to 0%) at initial recognition with a risk of a default occurring (of close to 100%) at the reporting date. Assume for the purposes of the example that the subsidiary's R&D project has progressed in line with initial expectations and economic conditions are in line with initial forecasts.

A question arises as to whether this implies that the demand loan in this example would be considered credit impaired (and therefore in **Stage 3**) simply because the subsidiary has used the funds to invest at the reporting date, irrespective of the fact that the project is performing as expected and economic conditions are in line with forecasts. We consider that there are two acceptable approaches.

BDO comment – Expected life and the maximum period to consider (continued)**Staging assessment (continued)****Approach 1**

The loan has a risk of a default occurring of 100% and consequently, it should be considered credit impaired and in **Stage 3**. This is because IFRS 9: 5.5.19 is clear that the maximum period to consider when measuring ECL is the maximum contractual period which, in this case, is 'on demand' irrespective of whether the parent intends to demand repayment at that date. It therefore follows that the staging assessment should be consistent with this principle. The fact that the subsidiary's underlying project is progressing according to plan and economic conditions are in line with forecasts is not relevant because the standard requires that the assessment of default should be made assuming repayment was demanded immediately. In this example, this means that because the subsidiary does not have sufficient funds to repay the loan on demand at the reporting date, then the loan should be considered credit impaired and in **Stage 3**.

Approach 2

The loan has a risk of a default occurring of 100% but should remain in **Stage 1** until such time as the parent considers that there has been significant increase in credit risk in comparison with that which was anticipated at initial recognition (at which point the loan would transfer to **Stage 2**) or evidence of that the loan has become credit impaired (at which point the loan would transfer to **Stage 3**). This is because even though IFRS 9: 5.5.19 is clear that the maximum period to consider when measuring ECL is the maximum contractual period which, in this case, is 'on demand' irrespective of whether the parent intends to demand repayment at that date, the staging assessment should illustrate changes in initial expectations of credit risk. In this example, changes in credit risk would be demonstrated qualitatively through an assessment of whether the underlying R&D project is performing (and is expected to continue to perform) in line with expectations and whether economic conditions are in line with forecasts. This means that if, at initial recognition, the parent company expected that the loan would have a very high risk of default for the first 3 years (while the subsidiary developed its underlying project) and a very low risk of default thereafter (once the underlying project was developed allowing the subsidiary to either repay the loan or refinance), then it would only be appropriate for the loan to transfer from **Stage 1** if those expectations had changed taking into account relevant reasonable and supportable information, including that which is forward-looking.

It is worth noting that the only significant difference between these two approaches in the context of an interest-free demand loan relates to the associated credit risk disclosures required by IFRS 7 (for example, IFRS 7: 35H and 35M require separate disclosure for financial assets in different stages) and not to recognition and measurement.

This is because under both approaches, assuming that the subsidiary does not have sufficient liquid assets to repay the loan if demanded at the reporting date, the risk of default is likely to be close to 100%. This means that under both approaches, when measuring ECL, the parent company will apply the same risk of default to the probability weighted expected credit loss outcomes. Furthermore, as the loan in question is not interest-bearing and has an EIR of 0%, there will be no effect on the recognition of interest income i.e. from a gross basis in **Stage 1** and **Stage 2** to a net basis in **Stage 3**.

Entities should choose what they consider to be the most appropriate approach as a matter of accounting policy and apply it consistently. Irrespective of which approach is applied, entities should ensure that disclosures about related company loans of this nature are adequate and enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

c) Incorporating reasonable and supportable information

Reasonable and supportable information that is available without undue cost or effort about past events, current conditions and forecasts of future economic conditions must be incorporated into the SICR assessment. The different types of information that must be considered and various sources of this information are set out in Section 5.2.

Incorporating forward-looking information reflects the fact that typically credit risk increases significantly before a financial instrument becomes past due²³. Therefore, relying solely on historical information such as payment defaults or past behaviour alone is generally not appropriate. Entities should consider the drivers of credit risk such as the borrower's other cash flow obligations (for example to other debt providers) its liquidity position and business performance. Secondly, it will need to determine the economic variables that could affect these drivers and ensure that relevant forward-looking information is being considered. Entities should also remember that in order to arrive at a probability-weighted outcome, a number of different scenarios and their relative weighting may need to be considered.

In cases where more forward-looking information is not available, there is a rebuttable presumption that there has been a SICR when payments are more than 30 days past due²⁴. However, similar to the 90 days past due rebuttable presumption in the case of defining default, this is a backstop indicator only and should not delay entities in identifying the point at which there has been a SICR.

BDO comment – Use of the 30 days past due rebuttable presumption

Relying upon the 30 days past due rebuttable presumption is unlikely to be appropriate for many related company loans. For example, in the case of an interest-free term loan, because the only payment obligation is due at maturity, using a days past due approach alone would not identify SICR on a timely basis throughout the life of the loan. Similarly, for an interest-free demand loan, the only payment obligation is the point at which the lender demands repayment, meaning that using a days past due approach will not identify a SICR unless payment has been demanded.

The longer the expected life of the loan, the more challenging the incorporation of forward looking information is likely to be as uncertainty increases over time.

²³ IFRS 9: B5.5.2.

²⁴ IFRS 9: 5.5.11., B5.5.19.- B5.5.21.

5.3.2. Factors to consider

The standard identifies numerous factors that could affect the borrower's ability to meet its future loan payment obligations, which may be relevant when assessing for SICR²⁵. These include actual or expected changes in:

- The operating results of the borrower such as declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage or liquidity problems;
- The regulatory, economic, or technological environment of the borrower such as a new regulations preventing business development, new technology rendering the borrower's products obsolete or a fall in market prices for the borrower's product;
- The business, financial or economic conditions such as a recession or increased levels of competition resulting in declining sales;
- The credit spread element of the market rate of interest;
- Internal or external credit ratings;
- Loan documentation e.g. breach of covenant or interest waivers;
- Past due information (including the 30 days past due rebuttable presumption); and
- The credit risk of other loans to the borrower e.g. evidence of late payments or interest waivers.

The relevance of these factors very much depends on the individual facts and circumstances for each loan. For example, many related company loans are advanced on an interest-free basis or indeed without any contractual terms at all. As a result, factors such as past due information or covenant waivers are unlikely to be relevant due to the lack of frequent payment obligations and/or the fact that the loan terms do not contain any covenants. Similarly, unless the entity is in the business of advancing credit, it is unlikely to have sophisticated processes for assessing and monitoring credit risk and therefore factors such as internal credit ratings are unlikely to be available.

For example, consider a 5-year interest-free term loan advanced to a mining company. Past due information relating to the loan would not be a relevant factor to consider in assessing for SICR given that no payments are due until maturity. However, expected cash flow projections relating to the entity's mining operations are likely to be relevant. In addition, assuming the entity has imputed a market rate EIR at initial recognition, it may also consider whether that market rate would have been different based on conditions at the reporting date.

²⁵ IFRS 9: B5.5.17.

BDO comment – Other operational simplifications

In addition to the 30 days past due rebuttable presumption, the standard also contains other operational simplifications that can be used when assessing for SICR.

Low credit risk exception

*If a loan has 'low credit risk' at the reporting date, then it can be assumed that the loan is in **Stage 1** with 12-month ECL being recognised. IFRS 9 considers credit risk to be low when there is 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. An example of low credit risk is an external rating **or** an equivalent internal rating of investment grade or above. This means that if the borrower is externally rated at or above investment grade (or is comparably rated using the lenders internal credit ratings system), it can be considered low credit risk.*

Many related company loans are advanced to entities that are not externally rated and corporates in particular are unlikely to have internal credit rating systems that would derive comparable ratings. In addition, related company loans are often advanced on terms that are not arms-length (or without any contractual terms) and in some cases, with little or no expectation of repayment for the foreseeable future. Consequently, they are very unlikely to be considered low credit risk under the criteria set out in IFRS 9. [See IFRS 9: 5.5.10., B5.5.22.- B5.5.24.]

Using changes in the risk of default over 12 months instead of over the expected life

If a loan has payment obligations spread evenly over its term and if changes in macroeconomic conditions and other credit related factors are adequately reflected in the risk of a default occurring in the next 12 months, it may be possible to assess for SICR using changes in the risk of a default occurring over 12 months instead of the expected life.

This simplification is not relevant for related company loans that are due on demand as the 12 month and lifetime risk of default will be the same. This would also appear unlikely to be an appropriate method for many related company term loans because they often have significant payment obligations concentrated close to maturity. [See IFRS 9: B5.5.13.- B5.5.14. and Illustrative Example 8: Scenario 2]

For the reasons set out above, this publication does not cover either of these operational simplifications in any detail and the examples that follow assume that they are not applicable.

5.4. Credit Impaired

In order to determine whether a loan should transfer to **Stage 3**, an entity needs to determine whether that loan is credit impaired at each reporting date. In **Stage 3**, interest income recognition moves from a gross to net basis (in subsequent reporting periods) but there is no change to the basis of ECL recognition – i.e. lifetime ECL continues to be recognised.

BDO comment – Loans with an EIR of 0%

The change in interest income recognition from a gross to a net basis will only affect loans that have an EIR. In the context of interest-free related company loans, this means that only those interest-free term loans for which an EIR is imputed at initial recognition will be affected. Interest-free demand loans that carry a 0% EIR will not be affected. However, IFRS 7 requires separate disclosure of all credit impaired loans irrespective of the size of the EIR.

In contrast to the SICR assessment, which focuses heavily on expected future events, the assessment of whether a loan is credit impaired focuses on events that have already taken place which provide evidence of impairment. That is, when one or more events that have a detrimental impact on the estimated future cash flows of the loan have occurred. Appendix A of IFRS 9 provides a number of indicators of a credit impaired financial asset which are wider than payment defaults, for example, they include events such as probable bankruptcy and granting the borrower concessions due to its' financial difficulty.

The credit-impaired indicators under IFRS 9 are largely similar to the indicators of objective evidence of impairment in accordance with IAS 39, with the exception of the indicator relating to a group of financial assets, commonly known as Incurred But Not Reported (IBNR) indicator²⁶.

BDO comment – Population of credit impaired loans under IAS 39 and under IFRS 9

Under IAS 39, related company loans would typically have been assessed on an individual rather than group basis and consequently the IBNR indicator is unlikely to have been relevant. Because the remaining IAS 39 indicators have been carried forward to IFRS 9 unchanged, it may therefore seem that the population of credit-impaired loans under IFRS 9 should be the same as the population of loans for which there was objective evidence of impairment under IAS 39. However, differences are likely to arise.

For example, under IFRS 9, there is now a very clear distinction between credit risk and loss amounts, evidenced by the fact that collateral and guarantees are generally excluded when assessing for SICR but generally included when measuring ECL. This means that under IFRS 9, a collateralised loan where the underlying borrower is highly likely to default but the ECL allowance is very small (owing to the value of the underlying collateral included in the measurement of ECL), is very likely to be considered credit impaired. Under IAS 39, this distinction was not as clear and consequently, such a loan may not have been considered impaired as long as the value of collateral was sufficient to cover any losses.

²⁶ IAS 39.59.

5.5. Measurement of Expected Credit Losses (ECL)

At each reporting date, once an entity has determined whether the loan is in **Stage 1**, **Stage 2** or **Stage 3**, it must then measure either 12-month ECL (**Stage 1**) or Lifetime ECL (**Stage 2** and **Stage 3**) accordingly.

BDO comment – ECL Measurement

Measuring ECL is a new requirement introduced by IFRS 9 and similar to the SICR assessment, is likely to be a challenging and judgmental area because the standard does not specify a particular method of measuring ECL. One ECL measurement approach that is applied in a number of the Illustrative Examples in IFRS 9 is a methodology based on:

- The Probability of Default (PD) i.e. the risk of a default occurring (over 12 months or the expected life);
- The Loss Given Default (LGD) i.e. the percentage loss that arises if a default occurs; and
- The Exposure at Default (EAD) i.e. amounts owed under the loan at the point of default.

For example, if the 12-month PD was 5%, the LGD was 60% and the EAD was CU100, then 12-month ECL would be calculated as $5\% \times 60\% \times \text{CU}100$, i.e. CU3. This approach is particularly common in banking entities because in many cases, a similar methodology is already used for regulatory capital purposes and while various adjustments are required, it can be a useful starting point for ECL measurement. Some non-banking entities may choose to apply a similar approach although it would be likely to be a less sophisticated model than that used by banking entities. However, there is no requirement to apply the 'PD x LGD x EAD' method or develop another complex statistical model. One alternative approach to the measurement of ECL could be as follows:

- Estimate possible credit losses that could arise upon a default (bearing in mind that there is likely to be more than one scenario to consider, in which case a weighted average should be calculated); and
- Weight this amount in accordance with the estimated risk of a default occurring (over 12 months or the expected life accordingly).

While both approaches will present similar challenges e.g. estimating expected cash flows, assessing the risk of default and incorporating forward-looking information, some entities may find a less banking focused approach more appropriate to their circumstances.

Ultimately, entities will need to make their own judgment as to which measurement approach they should use taking into account how sophisticated the entity is, the internal and external information available and the characteristics of their financial instruments. However, the approach used should incorporate the key measurement requirements, be sufficiently documented, subject to regular review and applied consistently for similar loans. Entities should also be aware that IFRS 7 also requires entities to disclose inputs, assumptions and estimation techniques used to measure ECL.

The standard sets out a number of different requirements that must be taken into account when measuring ECL and these are discussed below. However, before we consider these requirements, it is important to understand how IFRS 9 defines credit losses, ECL, 12-month ECL and Lifetime ECL.

Credit Losses	Present value of the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive (i.e. the present value of all cash shortfalls).
ECL	Probability-weighted estimate of credit losses over the expected life of the financial instrument.
Lifetime ECL	ECL that result from all possible default events over the expected life of the loan.
12-month ECL	A portion of lifetime ECL that result from default events that are possible within the 12 months after the reporting date i.e. not just the cash shortfalls that are expected to arise within the next 12 months but a portion of the lifetime ECL arising as a result of a default occurring within 12 months ²⁷ .

This distinction between 12 month and Lifetime ECL is important and can be particularly relevant for interest-free loans where no payment obligations are due until maturity.

Example 8 – 12-month ECL – A portion of lifetime ECL

On 1 January 2018, Parent A provides Subsidiary B an interest-free loan of CU100,000 repayable in 5 years. The loan meets the criteria to be classified at amortised cost and is within scope of the ECL model (General Approach).

At 31 December 2018, assume:

- No SICR: loan in **Stage 1** (12-month ECL required)
- Credit loss (cash shortfall):
 - Over the next 12 months = CU0
 - Over the expected life = CU60,000
- Probability of Default (PD):
 - Over the next 12 months = 10%
 - Over the expected life = 30%

Therefore, even if the loan defaults within 12 months, no credit losses arise during that period.

Question: Can Parent A conclude that the 12-month ECL amount is zero?

²⁷ IFRS 9: B5.5.43.

Analysis

No. Parent A must take the lifetime credit losses of CU60,000 into account when measuring 12-month ECL because even though those losses do not arise within 12 months, they arise as a result of a default event that is possible within that period. Therefore, 12-month ECL are calculated by multiplying the 12-month PD by the lifetime credit losses that would arise as a result i.e.

– 12-month ECL = 10% x CU60,000 = CU6,000.

If Parent A did not take the full lifetime credit losses into account, the 12-month ECL would not represent the portion of Lifetime ECL arising from a default event within the next 12 months.

In contrast, if there had been a SICR and lifetime ECL was required to be recognised, this would be calculated by multiplying the lifetime PD by the lifetime credit losses that would arise as a result of that default as follows:

– Lifetime ECL = 30% x CU60,000 = CU18,000.

This means that the difference between 12 month and Lifetime ECL arises as a result of the different risks of default that are applied i.e. 10% for 12-month ECL and 30% for Lifetime ECL.

BDO comment – 12 month and Lifetime ECL for loans with an expected life of 12 months or less

*For loans that have an expected life of 12 months or less, such as demand loans, the risk of a default occurring over 12 months will be the same as the lifetime risk of a default occurring, which means that the 12-month and Lifetime ECL will be the same. However, IFRS 7 still requires separate disclosure for loans in **Stage 1**, **Stage 2** and **Stage 3** and consequently, the general approach must still be applied.*

*For loans that have an expected life of more than 12 months, the 12-month risk of default will be smaller than the lifetime risk of a default because of the longer period of time that needs to be considered. In these cases, determining whether the loan is in **Stage 1**, **Stage 2** or **Stage 3** will be crucial because the 12-month ECL may be considerably lower than Lifetime ECL.*

5.5.1. Key Requirements for ECL Measurement

The standard acknowledges that the ECL allowance can be measured using different methods provided the amount calculated includes the following²⁸:

- a) An unbiased and probability-weighted amount;
- b) The time value of money; and
- c) Reasonable and supportable information that is available without undue cost or effort.

²⁸ IFRS 9: 5.5.17.

a) Unbiased and probability-weighted amount

There is no expectation for entities to consider every possible scenario but they are expected to consider a range of possible outcomes when measuring ECL. At a minimum the standard requires two outcomes to be considered i.e. the possibility that a credit loss occurs and the possibility that no credit loss occurs (even if the possibility of a credit loss occurring is very low). This means that considering only the best or worst estimate or most likely outcome will not necessarily be sufficient to meet this requirement²⁹.

BDO comment – Implications of a probability weighted measure

*The fact that entities are required to consider the possibility of a loss occurring means that there should always be some amount of ECL to recognise for each loan whether it is in **Stage 1**, **Stage 2** or **Stage 3**. However, to the extent that the underlying borrower is in a strong financial position or if the loan benefits from sufficient forms of credit enhancement to cover any losses, the ECL amount may be small and in some cases immaterial. For example, an entity may consider five possible scenarios, only one of which results in a loss. If the likelihood of the scenario that would result in a loss is very low, for example, a 1% chance of occurring, then this may result in an immaterial credit loss (subject to the effect of any discounting).*

*It is also worth noting that even for loans that were already impaired under IAS 39 and are in **Stage 3** under IFRS 9, the provision amount recognised is likely to be different. This is because many entities would have applied a best estimate approach determining their impairment provisions under IAS 39 whereas a probability-weighted amount is required under IFRS 9.*

b) Time Value of Money

Credit losses in accordance with IFRS 9 represent the present value of cash shortfalls and therefore include the time value of money. This means that even if all cash flows are expected to be received in full but received late, this will result in ECL because it represents lost interest on amounts past due. The appropriate discount rate to use for a fixed rate loan is the original EIR or for a loan with a return based on a benchmark variable rate such as LIBOR, the current EIR. This should also be the rate that is being used to recognise interest income using the EIR method³⁰.

BDO comment – Time value of money for loans with 0% EIR

Incorporating the time value of money will affect interest-free related company loans differently depending on whether they are term loans or demand loans. In the case of an interest-free term loan for which an EIR has been imputed at initial recognition, late payment of amounts owed will give rise to an ECL. This is because interest revenue is being recognised using the original EIR and that rate must also be used to discount ECL.

In contrast, for an interest-free demand loan with an EIR of 0%, the late payment of contractual cash flows will not give rise to an ECL. No interest revenue is being recognised because the EIR is 0% and applying this rate to discount the late payment of future cash flows will have no effect.

²⁹ IFRS 9: 5.5.17., B5.5.41. - B5.5.43.

³⁰ IFRS 9: B5.5.44.

c) *Incorporating reasonable and supportable information*

Reasonable and supportable information that is available without undue cost or effort about past events, current conditions and forecasts of future economic conditions must be incorporated into the measurement of ECL. The different types of information that must be considered and various sources of this information are set out in Section 5.2.

In the first instance, entities need to determine the drivers behind credit losses. This could include the borrower's other cash flow obligations (for example to other debt providers), the value of collateral or other credit enhancements, the quality and liquidity of the borrower's assets and the value of its underlying business.

Secondly, entities need to determine the economic variables that could affect these drivers and ensure that forward looking information is being considered. For example, if a loan is secured by collateral, then the value of that collateral should generally be considered when measuring ECL (see Section 5.5.2.). The value considered should represent the value at the point at which the property could be sold and therefore, economic variables relevant to property prices at that point in the future should be considered. The longer the expected life of the loan and/or the longer the recovery period, the more challenging the incorporation of forward-looking information is likely to be as uncertainty increases over time.

BDO comment – Multiple scenarios

Entities need to remember that a number of different future economic scenarios may need to be considered in cases where a particular scenario or factor does not affect credit losses in a linear fashion. This is because IFRS 9 requires that ECL must be a probability-weighted amount. For example, consider a case where there are three different scenarios:

- *Best case (10% possibility): results in a credit loss of CU100,000;*
- *Most likely case (60% possibility): results in a credit loss of CU150,000;*
- *Worst case (30% possibility): results in a credit loss of CU350,000.*

In this example, the impact of the different scenarios on credit losses is not linear because the best-case scenario only reduces losses by CU50,000 to CU100,000 whereas the worst-case scenario increases credit losses by CU200,000 to CU350,000. If only the most likely scenario was considered, this effect would not be captured as illustrated below:

- *Most likely case (60% possibility):*
 - *Credit loss of CU150,000.*
- *Weighted average of credit losses arising in each scenario:*
 - *$(10\% \times \text{CU}100,000) + (60\% \times \text{CU}150,000) + (30\% \times \text{CU}350,000)$;*
 - *CU10,000 + CU90,000 + CU105,000;*
 - *Credit loss of CU205,000.*

5.5.2. Credit Enhancements

It is common for loans to benefit from different forms of credit enhancement such as collateral or guarantees that protect the lender from losses incurred in the event of a borrower default. For example, if a loan is secured by a property, this asset can be seized by the lender and sold in the event of a borrower default in order to recoup amounts due under the loan. Similarly, if a loan benefits from a financial guarantee, the lender can claim from the guarantor for losses arising on the loan as a result of the borrower's failure to pay amounts due.

As noted in Section 5.3.2.(b)(ii), these credit enhancements are generally excluded from the SICR assessment. However, cash flows from the sale of collateral held or other credit enhancements are included when measuring ECL provided they are:

- Integral to the contractual terms of the financial instrument; and
- Not recognised separately by the entity³¹.

Credit enhancements that are not explicitly part of the contractual terms may still be considered as integral to the contractual terms. For example, a separate financial guarantee contract entered into at the same time as a loan where the premium paid is considered a transaction cost (i.e. part of the EIR on the loan) would be integral to the contractual terms of the loan as there is only one single unit of account. However, this is a judgmental area and will depend upon the specific facts and circumstances of each case. Credit enhancements that are recognised separately, for example a credit default swap, must be excluded from the measurement of ECL in order to avoid double counting.

The expected timing of any cash flows arising should also be taken into account along with any costs of obtaining and selling any collateral.

5.5.3. Maximum Period to consider

The maximum period to consider when measuring ECL is defined in IFRS 9 as the maximum contractual period (including extension options) over which the entity is exposed to credit risk but can be shortened by prepayment expectations³². Only borrower extension options are considered to lengthen the period of credit exposure because in the case of a lender extension option, the lender has a choice not to extend. This is the case even if the lenders past business practice and/or future expectations suggest that the extension option will be exercised.

This means that when measuring ECL for demand loans, entities must assume that the contractual cash flows are due immediately **even if the lender has no intention of demanding repayment**. Credit loss scenarios must then be calculated based on the various possible recovery strategies available at that point. As explained at the end of Section 5.3.1.(b)(iii), this requirement also has important consequences for the estimation of the risk of a default occurring and the staging assessment for demand loans.

³¹ IFRS 9: B5.5.55.

³² IFRS 9: 5.5.19.

5.6. Application Examples

In this section, the ECL requirements above are applied to two different related company loans; an interest-free term loan and an interest-free demand loan.

5.6.1. Applying the ECL model to an interest-free term loan

Parent A operates in the UK retail sector, specialising in clothing, and has several subsidiaries operating in different regions across the country. Parent A can obtain third party funding at more competitive market rates than its subsidiaries and consequently, it frequently obtains external funding and on lends to its subsidiaries on an interest-free basis.

Subsidiary B operates in Region Y. To date, the entity has performed well and is currently embarking on an investment plan to refurbish its retail premises and further develop its on-line offering. On 1 January 2018, Parent A lends Subsidiary B GBP10 million to fund these investments with the following terms:

- Repayable in 3 years – December 2020;
- Interest-free (the market rate of interest for a similar loan is 15%).

Subsidiary B also has a loan of GBP1 million from Bank X which was taken out several years ago and is also due for repayment in December 2020. The bank loan bears a market rate of interest and is senior to the loan from Parent A.

At initial recognition, Parent A concludes that the loan is not purchased or originated credit impaired (POCI) and meets the criteria to be classified at amortised cost. Parent A initially recognises the loan at its fair value of GBP6.575 million, which is equal to the present value of GBP10 million due in December 2020, discounted at 15% (the market rate of interest for a similar loan). This initial amount will accrete to GBP10 million over the life of the loan by applying the Effective Interest Rate (EIR) method.

Parent A records the difference between the initial amount recognised of GBP6.575 million and the amount of cash advanced of GBP10 million i.e. GBP3.425 million as an increase in Parent A's investment in Subsidiary B. The initial amounts recognised by Parent A are as follows:

	DR (GBP)	CR (GBP)
Initial Gross Carrying Amount	6,575,000	-
Investment in Subsidiary B	3,425,000	-
Cash	-	10,000,000

At initial recognition, Parent A makes an assessment as to the initial credit risk of the loan over its 3-year life. Parent A does so by taking into account available relevant information about Subsidiary B's past, current and expected operating performance and cash flow position (which includes forward looking information) and notes the following:

- Key business risks include (i) the general economic environment, in particular unemployment, consumer confidence and inflation (ii) changing consumer preferences/trends and (iii) the competitive environment. All of these factors have an effect on Subsidiary B's key performance indicators (KPIs) relating to operating profit, liquidity position and cash flow projections, which in turn affect Subsidiary B's ability to meet its payment obligations;
- Current cash flow projections which include full repayment of the bank loan, suggest that Subsidiary B is expected to be able to fund the repayment of the loan to Parent A in December 2020.

Parent A has various accounting policies relevant to its interest-free term loans:

- **Definition of default** – A loan is considered to be in default when there is evidence that the borrower is in significant financial difficulty such that it will have insufficient liquid assets to repay the loan when due. This is assessed based on a number of factors including key liquidity and solvency ratios. Relying on the 90 days past due rebuttable presumption is not considered an appropriate backstop indicator given the lack of contractual payment obligations due throughout the life of the loan. Instead, as a backstop indicator, Parent A sets a minimum threshold for what it considers to be the key solvency ratio and in the event that threshold is breached, a default is assumed to have occurred.
- **SICR assessment** – When assessing for changes in credit risk since initial recognition, Parent A performs a qualitative assessment. It primarily focuses on a comparison of forecasted KPIs over the expected life of the loan at initial recognition to forecasted KPIs over the remaining expected life of the loan at the reporting date (taking into account forward looking information such as the updated economic and business environment).

Parent A makes this comparison by using various operating performance ratios as well as liquidity/cash flow coverage ratios and considers that if initial forecasts have not been (or **are not expected to be**) achieved for a period of 6 months or more, then this would constitute a SICR. When making this determination, Parent A applies certain tolerance levels for each ratio in order to avoid very small deviations from forecasts (which Parent A **does not consider to be significant**) resulting in a SICR.

Relying on the 30 days past due rebuttable presumption as a backstop indicator is not considered appropriate given the lack of contractual payment obligations due throughout the life. Instead, as a backstop indicator, Parent A assumes that a SICR has occurred if the key solvency ratio identified by Parent A falls below a particular limit. In addition, amounts past due or breaches of covenant relating to any external loans are taken into account.

- **Credit impaired indicators** – A loan is considered credit impaired if it meets the definition of a defaulted loan.

Determining whether the loan is in Stage 1, Stage 2 or Stage 3

At the reporting period-end of 31 December 2018, which is the first reporting date following initial recognition of the loan, Parent A notes that since initial recognition:

- Economic conditions across the UK, including Region Y, have become increasingly uncertain due to Brexit related concerns, which has led to declining consumer confidence and a depreciation in the value of GBP – both of which have led to increased inflation. For Subsidiary B, this has resulted in increasing supplier costs, decreasing sales volumes and lower operating profits;
- One of the largest employers in Region Y closed down unexpectedly causing an increase in unemployment levels which will have a negative effect on sales volumes;
- Subsidiary B has not defaulted on any of its loan payment obligations to Bank X nor has it breached any covenants;
- Subsidiary B's KPIs have been considerably lower than initial forecasts (beyond permitted tolerance levels) for a period of 4 months and this trend is expected to continue for at least the next 6-8 months; and
- Subsidiary B is still expected to have sufficient funds to repay the loan to Bank X and to Parent A in 2020 and in addition the key solvency ratio has not breached the SICR backstop limit set by Parent A.

While the SICR backstop indicator has not been breached, KPIs have been declining for a period of 4 months and this is expected to continue for at least another 6-8 months. Based on Parent A's accounting policies, it concludes that there has been a SICR. Therefore, the loan is in **Stage 2** and lifetime ECL must be recognised.

Estimation of the lifetime risk of a default occurring

BDO comment – Using the maximum risk of default

In this example, Parent A derives the risk of a default occurring using a considerable amount of management judgment and methods that are not statistical in nature. As a result, it may choose to apply a worst case scenario (i.e. 100% risk of default) in the first instance, in order to determine whether or not the resulting ECL would be material. However, should that amount be material, one possible approach to estimating the actual lifetime risk of a default occurring is set out below.

Parent A is not in a position to develop statistical models to calculate probabilities of default without undue cost or effort. Instead, it considers several different sources of information in order to derive a less complex measure of the risk of a default occurring.

Parent A first considers historical information:

- **Internal information** – If Parent A had information available internally about past default rates (for loans advanced on similar terms to similar counterparties), these could be used as a starting point for calculating the lifetime risk of a default occurring. However, Subsidiary B has never defaulted on its loans and while other subsidiaries have defaulted in the past, these defaults occurred many years ago and Parent A does not consider Subsidiary B's position to be comparable.
- **External information** – While it is possible to obtain information about the historical default rates for loans to other entities in the retail sector, those entities typically have lower gearing levels than Subsidiary B. In addition, the loans advanced to these entities are generally interest bearing and senior ranking, whereas Subsidiary B's loan is interest-free and junior in nature. Parent A concludes that it would not be appropriate to use this external data in isolation but considers that this information could be a useful source of independent challenge for its own estimate of the lifetime risk of a default occurring for the loan to Subsidiary B. This is because the lifetime risk of a default occurring for the loan to Subsidiary B should be considerably higher than that suggested by the external information due to the higher gearing levels and more junior nature of the loan. Parent A therefore decides to source this information from an external provider (for which it pays a fee). This data indicates a 12-month historical default rate of 7%. Assuming a constant default rate over the remaining 2 years of the loan to Subsidiary B, this would imply an approximate historical lifetime default rate of 13.5% i.e. 7% marginal risk of default in 2019 plus 6.5% (7% x 93%) marginal risk of default in 2020.

Parent A then considers other relevant forward looking information that could be used to measure the risk of a default occurring over the expected life of the loan to Subsidiary B. In accordance with Parent A's accounting policies, insufficient liquidity of the borrower to repay the loan when due (as evidenced by key liquidity and solvency ratios) would constitute a default. Based on Subsidiary B's current forecasts which assume the most likely expected business and economic conditions (base case), no such default arises. However, because Parent A is required to at least consider the possibility of a credit loss occurring, it must consider other reasonably possible scenarios. It sources economic information about different expected unemployment and inflation rates from an external provider (for which it pays a fee) and considers the effect these alternative scenarios would have on Subsidiary B's forecasts³³.

Economic Scenarios	Likelihood	Default outcome
Scenario 1 (base case)	70%	No default
Scenario 2 (best case)	5%	No default
Scenario 3 (worst case)	25%	Default

Having performed this analysis, Parent A considers that the risk of a default occurring over the expected life taking into account forward looking information and other reasonably possible scenarios is 25%. Parent A notes that this is significantly higher than the historic lifetime default risk of default of 13.5% that would have been derived using external information which reflects both the less senior nature of the loan to Subsidiary B and the incorporation of forward looking information which was excluded from the external information.

³³ For the purposes of illustration, it is assumed that inflation and unemployment are the main drivers of credit risk. In reality, there may be several drivers and Parent A would need to perform a similar analysis on each one.

Measurement of ECL

In order to measure ECL, Parent A estimates the possible cash flows it expects to receive if Subsidiary B does default on the loan repayment of GBP10 million due in December 2020. In this example, Parent A considers the value of the underlying business operations and how best its recovery could be maximised. Parent A also takes into account the fact that the bank loan is senior to its loan.

Parent A considers a number of recovery strategies are available to it in the event of default. Subsidiary B may recover given time, in which case Parent A may choose to simply wait for recoveries. Alternatively, Parent A could force a sale of the underlying business or assets. However, because a 'fire sale' of assets could result in significantly discounted sales prices, Parent A anticipates that it would wind down its trading operations over a number of years allowing sales to take place over a period of time (in so far as possible) in order to maximise recovery value.

Having considered this information, and taking into account other relevant reasonable and supportable information (including forward-looking information), Parent A determines that recoveries would be maximised by giving Subsidiary B extra time to repay. It estimates three possible expected cash flow scenarios under that recovery strategy (*Scenarios 1, 2 and 3*) together with the likelihood of their occurrence. Parent A includes *Scenario 3* because even though the full amount of GBP10 million is expected to be recovered under this scenario, a credit loss will arise because the late payments amounts will be discounted at the EIR of 15%. Parent A also considers the possibility of forcing a sale of the underlying assets because despite being the least likely recovery strategy, it could result in significantly less cash flows being recovered and consequently greater credit losses (*Scenario 4*)³⁴.

Expected cash flow scenarios (undiscounted)	2019 (GBP)	2020 (GBP)	2021 (GBP)	2022 (GBP)	Total (GBP)
<i>Scenario 1 (20% likelihood)</i>	-	2,800,000	1,600,000	1,200,000	5,600,000
<i>Scenario 2 (60% likelihood)</i>		4,500,000	2,900,000	900,000	8,300,000
<i>Scenario 3 (15% likelihood)</i>	-	2,000,000	2,500,000	5,500,000	10,000,000
<i>Scenario 4 (5% likelihood)</i>	-	1,000,000	900,000	500,000	2,400,000

Parent A then discounts these cash flows by the original EIR of 15% in order to derive the present value amounts:

Expected cash flow scenarios (discounted)	2019 (GBP)	2020 (GBP)	2021 (GBP)	2022 (GBP)	Total (GBP)
<i>Scenario 1 (20% likelihood)</i>	-	2,117,000	1,052,000	686,000	3,855,000
<i>Scenario 2 (60% likelihood)</i>		3,403,000	1,907,000	515,000	5,825,000
<i>Scenario 3 (15% likelihood)</i>	-	1,512,000	1,644,000	3,145,000	6,301,000
<i>Scenario 4 (5% likelihood)</i>	-	756,000	592,000	286,000	1,634,000

³⁴ For the purposes of illustration, four scenarios are considered. In reality, entities will need to use their own judgment in determining how many scenarios need to be considered.

Even though *Scenario 2* is the most likely outcome, Parent A concludes that the other scenarios must also be considered in order to arrive at a probability weighted ECL amount that reflects different outcomes. Parent A therefore calculates four credit loss scenarios:

Credit Loss scenarios	Scenario 1 (GBP)	Scenario 2 (GBP)	Scenario 3 (GBP)	Scenario 4 (GBP)
Present value of contractual cash flows due ³⁵	7,561,000	7,561,000	7,561,000	7,561,000
Present value of expected cash flows	3,855,000	5,825,000	6,301,000	1,634,000
Credit Loss	3,706,000	1,736,000	1,260,000	5,927,000

Using this information, Parent A calculates weighted average of lifetime credit losses:

Weighted Average of Credit Losses	GBP
<i>Scenario 1 (20% likelihood)</i> [3,706,000 x 20%]	741,000
<i>Scenario 2 (60% likelihood)</i> [1,736,000 x 60%]	1,042,000
<i>Scenario 3 (15% likelihood)</i> [1,260,000 x 15%]	189,000
<i>Scenario 4 (5% likelihood)</i> [5,927,000 x 5%]	296,000
Weighted average	2,268,000

Finally, Parent A calculates lifetime ECL using the lifetime risk of a default of 25% and the weighted average of lifetime credit losses of GBP2,268 million:

- Lifetime ECL = 25% x GBP2,268,000;
- GBP567,000.

BDO comment – 12-month ECL

*If, in the example above, Parent A had concluded that there had not been a SICR and that the loan was in **Stage 1**, then a 12-month risk of default occurring would need to be calculated in order to measure 12-month ECL. As noted previously, an entity may choose firstly to calculate the ECL amount using a 100% risk of default occurring in order to determine whether the maximum ECL amount would be material. However, if that amount is material, entities would need to estimate the risk of a default occurring over the next 12 months using similar principles to those described above for the estimation of a lifetime risk of default.*

*An interest-free loan of this nature will have significant payment obligations at maturity and in these cases, we note that IFRS 9 acknowledges that there would generally be a concentration of default risk towards maturity. This means that the risk of a default occurring in earlier years is likely to be lower. However, it is important to note that **it would not be appropriate** to assume that the risk of a default occurring over the next 12 months was zero, simply because no payments were due during that period. Instead, entities would need to consider other more qualitative indicators of default such as changes in key financial ratios that could imply the potential financial difficulty of the borrower.*

³⁵ This represents the gross carrying amount of the loan as at 31 December 2018 – i.e. the present value of GBP10 million due on 31 December 2020 using a discount rate of 15%.

5.6.2. Applying the ECL model to an interest-free demand loan

Parent A operates a global exploration business specialising in base metals. The business model involves the identification and exploration of new projects that, if successful, are sold to other more specialised mining companies. Parent A has recently set up a new subsidiary, Subsidiary B for the purposes of undertaking a new exploration project. Subsidiary B is capitalised by CU500,000 of equity shares provided by Parent A.

On 1 January 2018, Parent A advances a loan of CU5 million to Subsidiary B:

- The loan is interest-free and repayable on demand;
- The purpose of the loan is to fund Subsidiary B's planned exploration project and investment in the project is expected to begin in March 2018;
- Subsidiary B has no other assets and no other liabilities and intends to place the funds on demand deposit until such time as the investment process begins;
- The expected repayment date of the loan depends upon the success of the exploration project which can be assessed once the initial exploratory work has been completed;
- Historically, repayment of loans of this nature may not take place for several years as even in cases where the project is successful, it may take time to find a suitable investor.

At initial recognition, Parent A concludes that the loan is not purchased or originated credit impaired (POCI) and meets the criteria to be classified at amortised cost. As the loan is due on demand and is interest-free it is recognised initially at CU5 million and has an EIR of 0%. In addition, the Parent A considers the risk of Subsidiary B defaulting on the loan at initial recognition is very low because Subsidiary B has not yet made its investment and holds the cash on deposit.

Parent A has various accounting policies relevant to its interest-free demand loans:

- **Definition of default** – A loan is considered to be in default when there is evidence that the borrower is in significant financial difficulty such that it will have insufficient liquid assets to repay the loan on demand. This is assessed based on a number of factors including key liquidity and solvency ratios. Relying on the 90 days past due rebuttable presumption is not considered an appropriate backstop indicator given the lack of contractual payment obligations due throughout the life of the loan.
- **SICR assessment** – The risk that the borrower will default on a demand loan depends on whether the subsidiary:
 - (i) Has sufficient cash or other liquid assets to repay the loan immediately (meaning that the risk of default is very low, possibly close to 0% and the loan is in **Stage 1**); or
 - (ii) Does not have sufficient cash or other liquid assets to repay the loan immediately (meaning that the risk of default is very high, possibly close to 100% and the loan is in **Stage 3**).

Parent A performs this assessment qualitatively by reference to the borrower's immediate cash flow and liquid asset position. Relying on the 30 days past due rebuttable presumption is not considered an appropriate indicator given the lack of contractual payment obligations.

- **Credit impaired indicators** – A loan is considered to be credit impaired if it meets the definition of a defaulted loan.

BDO comment – Approach to the staging assessment

As explained at the end of Section 5.3.1.(b)(iii), there are two possible approaches to the staging assessment for interest-free demand loans of the type described in this example:

- Under the first approach the staging assessment compares the risk of a default occurring over the expected life at initial recognition to the position at the reporting date. Owing to the fact that the expected life for a demand loan is 'on demand', this means that the staging analysis is binary because at the reporting date, the borrower will either have sufficient liquid assets to repay the loan on demand (meaning that the risk of default is very low and the loan should be in **Stage 1**) or it will not have sufficient liquid assets to repay the loan on demand (meaning that the risk of default is very high and the loan should be in **Stage 3**);
- Under the second approach, the staging assessment takes into account the lenders expectations of the risk of a default occurring at initial recognition. For example, if the lender had expected that the risk of default would be very high for the first number of years owing to the nature of the borrowers business, then the fact that the risk of default is close to 100% at the first reporting date should not by itself cause the loan to move into **Stage 2** or **Stage 3**. Under this approach, a demand loan would only move from **Stage 1** if there has been a change in initial expectations of credit risk – i.e. if there has been a significant increase in credit risk the loan would move to **Stage 2** or if there is evidence that the loan has become credit impaired the loan would move to **Stage 3**. Under this approach, the staging assessment will likely require a detailed consideration of qualitative factors relating to the actual and expected future performance of the underlying project together with actual and expected economic conditions.

In this example, Parent A applies the first approach i.e. it considers that a loan with a 100% risk of default is considered to be a credit impaired loan and in **Stage 3** of the ECL model. If Parent A had chosen the second approach, this would need to be reflected in its accounting policies above. However, as noted at the end of Section 5.3.1.(b)(iii), the only significant difference between these two approaches relates to the associated IFRS 7 disclosures. It has no effect on recognition and measurement because the measurement of ECL will be identical under both approaches and there is no effect on the recognition of interest income in this example as the EIR is 0%.

Determining whether the loan is in Stage 1, Stage 2 or Stage 3

At 31 December 2018, which is the first reporting period since initial recognition of the loan, Subsidiary B has invested a significant proportion of the loan proceeds into the exploration project. Initial results have been positive but due to the very early stage of the project, no alternative sources of finance are available. In addition, the exploration assets that have been invested in are not considered liquid. As a result, Parent A considers that if repayment was demanded, Subsidiary B would have insufficient liquid assets to repay the loan and there is therefore a very high risk of a default occurring, likely to be close to 100%.

This is in contrast to the position at initial recognition because at that point Subsidiary B had not yet invested in the exploration project and instead had placed the funds on demand deposit, accessible immediately. Consequently, the risk of a default occurring at that point was very low, likely to be close to 0%.

In accordance with Parent A's accounting policies, the loan is considered to be in default and therefore credit impaired at the 31 December 2018. Parent A concludes that the loan is in **Stage 3** and measures Lifetime ECL.

Measurement of ECL

In order to measure Lifetime ECL, Parent A evaluates different recovery options and credit loss scenarios. The success of the project is the most important factor that will drive credit losses and this in turn is driven by the operating capability of Subsidiary B, the economic environment and commodity prices. Parent A assesses the likely success of the project based on both internal and external information, including obtaining forecasted information about economic variables such as commodity prices from an external provider (for which it pays a fee).

Parent A has full access to information about the project and is aware the results of initial exploratory work have been positive and even though it is still in the very early stages, it is expected that the overall project will be a success. In addition, a number of mining companies have already expressed an interest in purchasing the investment once complete.

Having considered this information, and taking into account other reasonable and supportable information (including forward-looking information) about Subsidiary B, the economic environment and commodity prices, Parent A estimates two possible cash flow scenarios under this strategy (*Scenarios 1 and 2*) together with the likelihood of their occurrence. Parent A also considers the possibility that the project may fail because despite being unlikely, it would result in significantly less cash flows being recovered and consequently greater credit losses (*Scenario 3*)³⁶.

³⁶ For the purposes of illustration, three scenarios are considered. In reality, entities will need to use their own judgment in determining how many scenarios need to be considered.

These scenarios are illustrated below:

Expected cash flow	2019 (CU)	2020 (CU)	2021 (CU)	Total (CU)
<i>Scenario 1 (85% likelihood)</i>	-	5,000,000	-	5,000,000
<i>Scenario 2 (10% likelihood)</i>	-	-	4,000,000	4,000,000
<i>Scenario 3 (5% likelihood)</i>	-	-	500,000	500,000

In this example, the discounted expected cash flows are identical to the undiscounted expected cash flows because the loan has an EIR of 0%.

Even though *Scenario 1* is the most likely outcome, Parent A concludes that the other scenarios must also be considered in order to arrive at a probability weighted ECL amount that reflects the possibility of a loss occurring. Parent A therefore calculates three possible credit loss amounts:

Credit Loss scenarios	<i>Scenario 1</i> (CU)	<i>Scenario 2</i> (CU)	<i>Scenario 3</i> (CU)
Present value of contractual cash flows due ³⁷	5,000,000	5,000,000	5,000,000
Present value of expected cash flows on default	5,000,000	4,000,000	500,000
Credit Loss	-	1,000,000	4,500,000

Using this information, Parent A calculates the weighted average of lifetime credit losses:

Weighted Average of Credit Losses	CU
<i>Scenario 1 (85% likelihood)</i> [0 x 85%]	-
<i>Scenario 2 (10% likelihood)</i> [1,000,000 x 10%]	100,000
<i>Scenario 3 (5% likelihood)</i> [4,500,000 x 5%]	225,000
Weighted average	325,000

Finally, Parent A measures the lifetime ECL using the lifetime risk of a default occurring, which it assumes to be 100% (as Subsidiary B does not have the ability to repay the loan on demand at the reporting date) and the weighted average of lifetime credit losses of CU325,000:

- Lifetime ECL = 100% x CU325,000;
- CU325,000.

³⁷ This represents the gross carrying amount of the loan as at 31 December 2018 – i.e. the present value of CU5 million due on 31 December 2018 using a discount rate of 0%.

6. APPENDICES

6.1. Appendix A – Purchased or Originated Credit Impaired (POCI)

A POCI financial asset is one that is credit impaired financial asset at the point of initial recognition, which is often evidenced by the purchase, or origination being at a deep discount that reflects the incurred credit losses. However, the fact that a loan has high credit risk at origination does not automatically mean that the loan meets the POCI definition. Only loans for which there is evidence of an incurred loss event at initial recognition are considered to be credit impaired³⁸.

Purchased Credit Impaired

In the normal course of business, related company loans are unlikely to be purchased credit impaired as they are not typically bought and sold. However, this situation could potentially arise as part of a group re-organisation where an existing intragroup loan was transferred to another entity within the group.

Originated Credit Impaired

IFRS 9 notes that originated credit impaired loans are only expected to occur in unusual circumstances³⁹. One example in the context of related company loans would be if a parent company modified an already distressed loan to a subsidiary in such a way that it results in derecognition of the original loan and the recognition of a new credit impaired loan.

If a loan meets the definition of a POCI financial asset, it will be subject to special requirements both in the context of recognising interest income and recognising ECL, namely:

- Initial expected credit losses are factored into the EIR calculation i.e. a credit adjusted EIR is determined at initial recognition;
- Interest income is recognised using the credit adjusted EIR which is applied to the amortised cost (i.e. gross carrying amount less ECL);
- ECL is discounted using the credit adjusted EIR;
- Only cumulative changes in lifetime ECL since initial recognition are recognised; and
- Favourable changes in lifetime ECL are not limited to reversal of previous losses.

³⁸ See IFRS 9: Appendix A – definition of POCI and credit impaired financial asset and IFRS 9: B5.4.7.

³⁹ See IFRS 9: B5.5.26.

6.2. Appendix B – Issued Financial Guarantee Contracts (FGCs)

IFRS 9 retains the same financial guarantee definition as IAS 39 i.e. a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due in accordance with the terms of a debt instrument. Some common examples of contracts that meet, and do not meet, this definition are set out in the following table:

Contract Type	Meeting FGC definition?
Parent company guarantee over a subsidiary's bank loan which reimburses the bank for losses incurred if the subsidiary fails to pay.	Yes; relates to specific a debtor and debt instrument and only reimburses for losses incurred as a result of a failure to pay.
Parent company guarantee over the general obligations of a subsidiary.	No; not specific in nature and may include obligations other than debt instruments.
Credit Default Swap (CDS) that pays out in the event of a credit downgrade (which does not necessarily equate to an incurred loss).	No; reimburses the holder for losses that it may not incur. A CDS is a derivative and must be measured at Fair Value through Profit or Loss (FVPL).

Similar to IAS 39, if an entity that has previously asserted explicitly that it considers and accounts for FGCs as insurance contracts can elect to apply IFRS 4 *Insurance Contracts* instead of IFRS 9. Going forward under IFRS 17 *Insurance Contracts*, a similar option will be permitted. However, entities will need to consider the changes to the accounting for insurance contracts that IFRS 17 will introduce.

Accounting for FGCs under IFRS 9

IFRS 9 retains the same initial recognition requirements as IAS 39 for issued FGCs but introduces different subsequent measurement requirements.

An issued FGC is a financial liability and is initially recognised at fair value. If the FGC is issued to an unrelated party at arms-length, the initial fair value is likely to equal the premium received. If no premium is received (often the case in intragroup situations), the fair value must be determined using a different method that quantifies the economic benefit of the FGC to the holder. For example, if an interest rate of 7% is charged with the benefit of a guarantee and a rate of 10% would be charged without it, the interest rate differential of 3% could be considered to represent the economic benefit of the FGC to the holder. The present value of this differential over the term of the loan would therefore be the initial fair value.

Subsequently, the FGC is measured at the 'higher of':

- i. The IFRS 9 Expected Credit Loss (ECL) allowance; and
- ii. The amount initially recognised (i.e. fair value) less any cumulative amount of income/amortisation recognised.

Alternatively, it is possible to designate the FGC at FVPL but only in cases of an accounting mismatch or if the FGC is part of a portfolio that is managed and its performance evaluated on a fair value basis.

The change that IFRS 9 introduces relates to part (i) of the 'higher of' test. IAS 39 referred to the amount of any provision required under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* whereas IFRS 9 refers to the amount of ECL allowance as required under the General Approach.

The ECL allowance under IFRS 9 will be different to the IAS 37 provision amount because under IAS 37, a provision is not recognised until an outflow of resources is probable and the amount is reliably measurable, whereas under IFRS 9, there is no 'probable' threshold; instead, a minimum of 12-month ECL is required to be recognised at all times. In addition, under IAS 37, the provision amount is based on a best estimate whereas the IFRS 9 ECL allowance is a forward-looking probability weighted measure that must reflect the possibility of a loss occurring even if very unlikely. These differences are summarised in the table below:

	IAS 37 Provision	IFRS 9 ECL Allowance
Recognition threshold	Yes – probable	No – 12-month ECL minimum
Measurement approach	Best estimate	Forward looking and probability weighted

For example, even if there was only a 5% chance that a loss might occur, this possibility must be factored into the ECL calculation whereas under IAS 37, no provision would be recognised as the loss was not probable. This means that when applying the 'higher of' test, the ECL allowance is likely to be larger and recognised earlier than the IAS 37 provision; however, in cases where underlying borrower is in a strong financial position or where the existence of collateral or other credit enhancements could either prevent default or reduce the amount of loss incurred, the ECL allowance may not be very significant. The ECL allowance on a financial guarantee contract over the entire amount of a loan would generally be the same as the ECL allowance that the lender would have recognised without the guarantee.

These new requirements may present implementation challenges – in particular for corporate entities with cross company guarantee structures that may not previously have attracted an IAS 37 provision and where there may be a lack of relevant credit risk information.

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For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below.

Alternatively, please visit www.bdo.global where you can find full lists of regional and country contacts.

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