GRAP 104 Reference Group
Inter-entity loans
20 September 2023

A S B
ACCOUNTING STANDARDS BOARD

Disclaimer

The views and opinions expressed in this presentation are those of the individual. Official positions of the ASB on accounting matters are determined only after extensive due process and deliberation.

Acronyms and abbreviations

Acronyms and abbreviations	Description
FV	Fair value
FVTSD	Fair value through surplus or deficit
SPER	Statement of financial performance
SPOS	Statement of financial position
SPPI	Solely payments of principal and interest on the principal amount

Overview of GRAP requirements (Loan receivable)

Overview of today's session

- Overview of the GRAP requirements
  - Loan receivable
  - Loan payable
  - Residual interest
- Application of GRAP requirement
  - Distinguish between liability and residual interest
  - Initial recognition of interest free loan
  - Classification of loan receivable
  - Impact of subordination agreements
  - Letters of guarantee
  - Impairment considerations

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Loan receivable

Section	Requirement		
Scope	Meet the definition of a financial asset		
Initial recognition	Becomes a party to the contractual provisions of the agreement		
Classification	**At amortised cost**	**Cost**	**FVTSD**
	Held to collect contractual cash flows	Not applicable	1. All other loans receivable 2. Irrevocably designated
	Meet SPPI test		
Reclassification	Change in management model	Not applicable	Change in management model
Initial measurement	FV plus transaction cost	Not applicable	FV

Loan receivable

Section	**Requirement**		
Subsequent measurement	**At amortised cost**	**Cost**	**FVTSD**
	Effective interest rate method	Not applicable	FV
Modification that is not a derecognition	1. Amend gross carrying amount. 2. Recognise a modification gain or loss		
Impairment	Recognise a loss allowance	Not applicable	Not applicable
Derecognition	1. Use trade date accounting 2. Derecognise when contractual rights expire, are settled or waved, transferred risk and rewards of ownership or control.		
	Write off: Directly reduce the gross carrying amount		

Loan receivable

Section	Requirement		
	At amortised cost	Cost	FVTSD
Offsetting	Financial assets and liabilities may only be offset if certain criteria are met • Currently have a legally enforceable right to offset and • Intents to settle on a net basis or realise the asset and settle the liability simultaneously.		
Disclosures	Follow the disclosure for financial assets • Qualitative and quantitative disclosures • Disclose the category of financial assets • Disclosure of details of offsetting arrangement • Concessionary loan disclosures • Disclose the nature and extent of risks arising due to the loan receivable (e.g. credit risk and market risk)		

Loan receivable

Section	Requirement		
	At amortised cost	**Cost**	**FVTSD**
Presentation	1. FV adjustments are recognised in surplus or deficit 2. Interest received is recognised in surplus or deficit 3. Impairment gains or losses are recognised in surplus or deficit 4. Income tax on these transactions is accounted for in terms of IAS 12, Income Tax 5. Financial assets as a separate line on the face of the SPOS 6. Additional line items allowed on the face of the SPOS 7. When presenting current and non-current assets – they must be separately classified on the face of the SPOS		

Overview of GRAP requirements (Loan payable)

Loan payable

<table>
<tr><th>Section</th><th colspan="2">Requirement</th></tr>
<tr><td>Scope</td><td colspan="2">Meet the definition of a financial liability</td></tr>
<tr><td>Initial recognition</td><td colspan="2">Becomes a party to the contractual provisions of the agreement</td></tr>
<tr><td rowspan="2">Distinguish</td><td>Liability</td><td>Residual interest</td></tr>
<tr><td>Meet definition of a financial liability</td><td>No contractual obligation to:
1. Deliver cash or another financial asset
2. Exchange financial instruments under unfavourable conditions</td></tr>
<tr><td rowspan="2">Classification</td><td>Amortised cost</td><td>FVTSD</td></tr>
<tr><td>Always at amortised cost, unless designated</td><td>Irrevocably designated at FVTSD</td></tr>
</table>

Loan payable

Section	Requirement	
Reclassification	**Amortised cost**	**FVTSD**
	Shall not reclassify a financial liability	
Initial measurement	Fair value plus transaction cost	FV
Subsequent measurement	Effective interest rate method	FV
Modification that is not a derecognition	1. Amend gross carrying amount. 2. Recognise a modification gain or loss	
Derecognition	Derecognise the liability when the obligation is discharged, cancelled, expires or waived.	

Loan payable

Section	Requirement	
	Amortised cost	FVTSD
Presentation	1. Interest paid on the loan is recognised in surplus or deficit 2. Dividends paid on instruments classified as a financial liability 3. Income tax on these transactions is accounted for in terms of IAS 12, Income Tax 4. Gains and losses on remeasurement of liability (includes a right to the residual interest) recognised in surplus or deficit. Present separately if necessary	
Offsetting	Financial asset and liability may only be offset if certain criteria are met	

Loan payable

Section	Requirement	
	Amortised cost	**FVTSD**
Disclosures	1. Follow the disclosures for financial liabilities • Qualitative and quantitative disclosures • Disclose the category of financial liabilities • Disclosure of details of offsetting arrangement • Concessionary loan disclosures • Consider if loan was or is in default during the year and at the reporting date • Disclose the nature and extent of risks arising due to the loan receivable (e.g. liquidity risk and market risk)	

Overview of GRAP requirements (Residual interest)

Residual interest (issuer)

<table>
<tr><th>Section</th><th colspan="2">Requirement</th></tr>
<tr><td>Scope</td><td colspan="2">Exclude the recognition and measurement for residual interest issued</td></tr>
<tr><td>Initial recognition</td><td colspan="2">Excluded from the scope of GRAP 104</td></tr>
<tr><td rowspan="2">Distinguish</td><th>Liability</th><th>Residual interest</th></tr>
<tr><td>Meet definition of a financial liability</td><td>No contractual obligation to:
1. Deliver cash or another financial asset
2. Exchange financial instrument under unfavourable conditions</td></tr>
<tr><td>Initial measurement</td><td colspan="2">Excluded from the scope of GRAP 104</td></tr>
</table>

Residual interest (issuer)

Section	Requirement
Subsequent measurement	Excluded from the scope of GRAP 104
Presentation	1. Distributions to holders of residual interest are recognised directly in net asset 2. Transaction cost incurred on residual interest is recognised as a deduction from net assets (presented separately) 3. Income tax on these transactions is accounted for in terms of IAS 12, Income Tax 4. Changes in FV is not recognised 5. Remeasurements and refinancing are recognised in net assets
Offsetting	Not applicable
Disclosures	Excluded from the scope of GRAP 104

Residual interest (holder)

Section	Requirement
Scope	**Excluded** from the scope of GRAP 104 is • Interest in controlled entities – consider GRAP 35 • Interest in associates and joint ventures – consider GRAP 36 **Included** in the scope of GRAP 104 is **(it is a financial asset)** • When an entity elected to measure its investments in controlled entities, associates and joint ventures using GRAP 104 • Other investments in residual interests

Distinguish between liability and residual interest

Liability versus residual interest

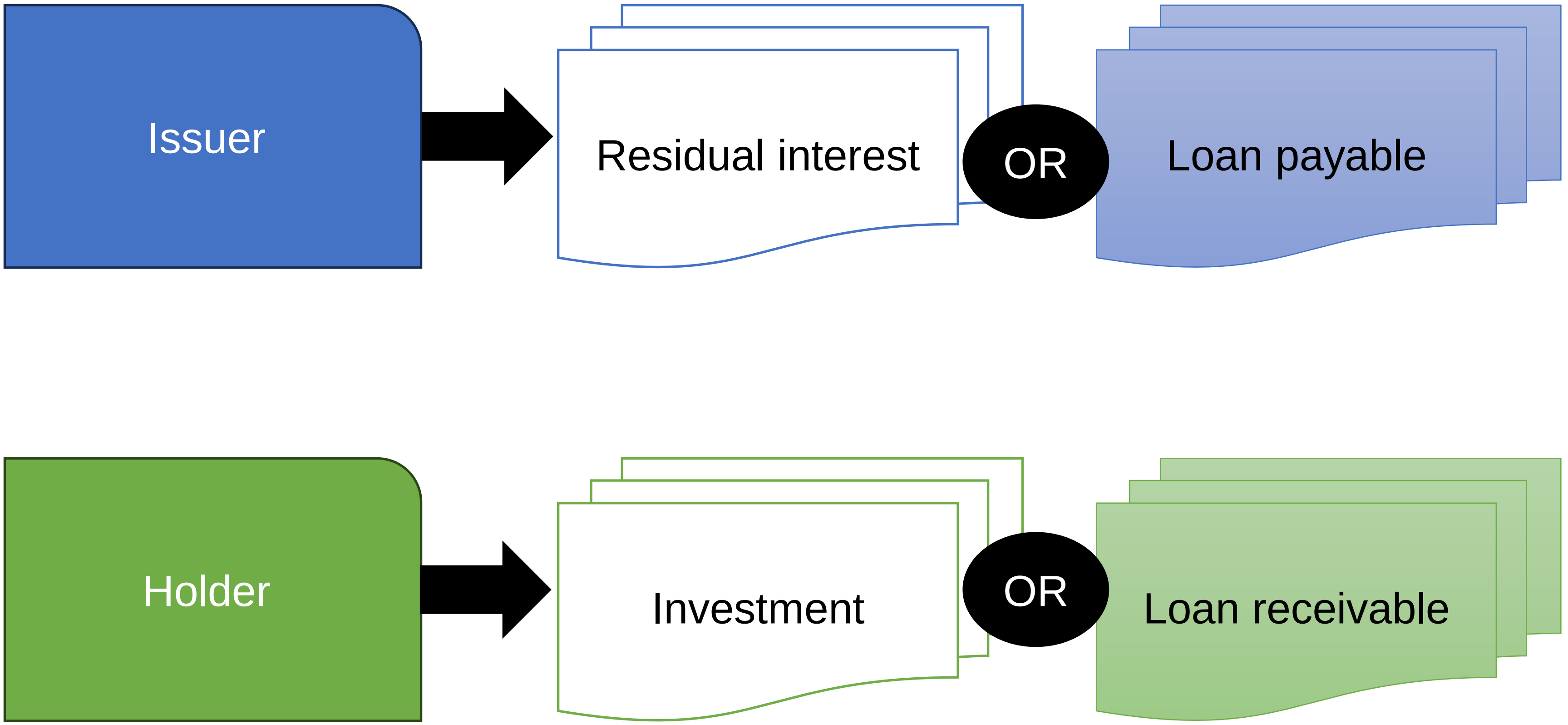
- On initial recognition, classify between financial liability and residual interest
- Consider the substance of the contract and the definitions per GRAP 104

Financial liability	Residual interest
Contractual obligation to:	**No** contractual obligation to:
1. Deliver cash or another financial asset to another entity; or	1. Deliver cash or another financial asset to another entity; or
2. Exchange a financial asset or liability with another entity under conditions that are potentially unfavourable to the entity	2. Exchange a financial asset or liability with another entity under conditions that are potentially unfavourable to the entity

Preference shares

Redeemable preference shares		
Requirement	**Classification**	**Reason**
Redemption on a specific date for cash	Financial liability	Issuer has the obligation to transfer cash
Redemption at the option of the holder for cash	Financial liability	Issuer has the obligation to transfer cash
Redemption at the option of the issuer for cash	Residual interest	Issuer has **no** obligation to transfer cash
Non-redeemable preference shares		
Requirement	**Classification**	**Reason**
Distribution at the discretion of the issuer	Residual interest	Issuer has **no** obligation to transfer cash

Loan scenario



Loan scenario

Repayable loans		
Requirement	**Classification**	**Reason**
Redemption on a specific date for cash	Financial liability	Issuer has the obligation to transfer cash
Redemption at the option of the holder for cash	Financial liability	Issuer has the obligation to transfer cash
Redemption at the option of the issuer for cash	Residual interest	Issuer has **no** obligation to transfer cash
Principal is not repayable		
Requirement	**Classification**	**Reason**
Interest at the discretion of the issuer	Residual interest	Issuer has **no** obligation to transfer cash

Contractual obligation to deliver cash

- Contractual rights and obligations
- Failure to enforce the rights and obligations
  - Does not change the nature of the transaction
  - Consider enforceability in terms of law

Scenario 1	Scenario 2
Controlled entity granted a loan to its controlling entity. The capital and interest are repayable quarterly. The controlling entity did not pay for 2.5 years, and the controlled entity did not enforce its rights.	Controlled entity granted a loan to its controlling entity. The capital and interest are repayable quarterly. The controlling entity did not pay for 15 years, and the controlled entity did not enforce its rights. The debt has prescribed.

Contractual obligation to deliver cash

Scenario 1	Scenario 2
Controlled entity granted a loan to its controlling entity. The capital and interest are repayable quarterly. The controlling entity did not pay for 2.5 years, and the controlled entity did not enforce its rights.	Controlled entity granted a loan to its controlling entity. The capital and interest are repayable quarterly. The controlling entity did not pay for 15 years, and the controlled entity did not enforce its rights. The debt has prescribed.
Failure to ensure the rights and obligations does not change the nature. The loan remains a financial liability.	The legal terms changed. The loan is no longer collectable. The loan must be derecognised.

Other considerations

Contingent settlement provisions

- Ignore the contingent settlement provision for classification if it’s not genuine.
- Not genuine: Extremely rare, highly abnormal and very unlikely

In consolidated financial statements

- Apply the definitions to the economic entity as a whole

No documentation

- Contract does not have to be in writing
- What are the rights and obligations

No documentation

- This happens often with related parties
- Is the money received a loan? Rights and obligations?
- Investigate the reason for the transfer of cash

Reason	Description
Liability	*A present obligation of the entity for an outflow of resources that results from a past event.*
Ownership contribution	*Inflows of resources to an entity, contributed by external parties in their capacity as owners, which establish, maintain or increase an interest in the net financial position of the entity.*
Non-exchange revenue	*Increase in the net financial position of the entity, other than increase arising from ownership contributions.*

Initial recognition of interest free loan

Interest free loan

- This is common practice between group entities
- Initially, financial instruments must be measured at fair value
- Paragraph AG5.4: Difference between the fair value and transaction price
  - FV is obtained from quoted prices in an active market or data from observable markets: Recognise a gain or loss
  - All other: Defer the difference
- Paragraph AG5.4 does not apply to concessionary loans
- Concessionary loans: Difference recognised in surplus or deficit or contribution to owners (Paragraph AG5.14 – AG5.16)

Interest free loan

- Paragraph AG5.14 – AG 5.16
- Assess the substance of the agreement. Is it a
  - loan or
  - investment
- A concessionary loan or investment granted is recognised as a financial asset with social benefit accounted for per the Framework
- Concessionary loan or investment received must be assessed if a part is:
  - A contribution from owners or
  - Non-exchange revenue

Interest free loan

- Paragraph AG5.25 – AG5.27
- Intention from the onset is to provide resources in a non-exchange transaction = non-exchange revenue
- When arrangement is unclear = ownership contribution

Interest free loan

- Example

The parent entity provides a loan to its controlled entity.	
Scope	Meet the definition of a financial liability
Loan	100,000
Repayment terms	5 payments – bi-annually – 20,000 per instalment
Interest rate	0% (interest free)
Market rate	10%
Present value at market rate	86,590

Interest free loan

- Example
- Step 1: Assess if the substance of the agreement is:
  - a loan (financial liability) or
  - Investment (residual interest)
- Step 2: Account for the concessionary loan or investment
  - Issuer: account for the Social benefit in surplus or deficit
  - Recipient / borrower: Account for a contribution from owners and/or non-exchange revenue

Interest free loan

From the parent entity (lender) perspective

- Scenario 1 : A concessionary loan is provided

The parent entity provides a loan to its controlled entity.	
Credit: Bank (SPOS)	(100,000)
Debit: Concessionary loan receivable (SPOS)	86,590
Debit: Social benefit (SPER)	13,410

Interest free loan

From the controlled entity (borrower) perspective

- Scenario 1 : A concessionary loan is provided with non-exchange revenue

The parent entity provides a loan to its controlled entity.	
Debit: Bank (SPOS)	100,000
Credit: Concessionary loan payable (SPOS)	(86,590)
Credit: Non-exchange revenue (SPER)	(13,410)

Interest free loan

From the controlled entity (borrower) perspective

- Scenario 2: A concessionary loan is provided with an owner contribution

The parent entity provides a loan to its controlled entity.	
Credit: Bank (SPOS)	(100,000)
Debit: Concessionary investment (SPOS)	86,590
Debit: Owner contribution / net assets (SPOS)	13,410

Interest free loan

From the controlled entity (borrower) perspective

- Scenario 2: A concessionary loan is provided with an owner contribution

The parent entity provides a loan to its controlled entity.	
Credit: Bank (SPOS)	(100,000)
Debit: Concessionary investment (SPOS)	86,590
Debit: Owner contribution / net assets (SPOS)	13,410

Classification of loan receivable

Classification of loan receivable

- Loan receivable is classified as
  - At amortised cost or FVTSD
- For amortised cost, two criteria must be met
  - Managed with the objective to collect the contractual cash flows
  - Contractual cash flows must meet the SPPI test
- SPPI test
  - Normal lending arrangement

Classification of loan receivable

- Example 1

Terms and conditions	
Interest-free loan, repayable in 5 bi-annual instalments	
Is SPPI test met?	
Repaid on specified dates?	Yes. Bi-annually. Specific dates do not have to be mentioned
Payment of principal?	Yes
Payment of interest on principal?	No. However, the repayment need not include capital and interest but may not represent anything other than capital and interest.
Is SPPI test met?	Yes
Classification of the loan	
Subsequently measured as at amortised cost	

Classification of loan receivable

- Example 2

Terms and conditions	
Interest accrues at 7.5% per annum and repayable on demand.	
Is SPPI test met?	
Repaid on specified dates?	Yes. Repayable on demand. Specific dates do not have to be mentioned
Payment of principal?	Yes
Payment of interest on principal?	Yes
Is SPPI test met?	Yes
Classification of the loan	
Subsequently measured as at amortised cost	

Classification of loan receivable

- Example 3

Terms and conditions	
Interest accrues at 7.5% per annum and no fixed repayment date.	
Is SPPI test met?	
Repaid on specified dates?	No specified dates.
Payment of principal?	Yes
Payment of interest on principal?	Yes
Is SPPI test met?	Yes
Classification of the loan	
Subsequently measured as at FVTSD.	

Impact of subordination agreement

Financial liabilities

Remember:

- Residual interest is when there is no contractual obligation to deliver cash or another financial asset
- Financial liability is a contractual obligation to deliver cash or another financial asset
- Financial liabilities cannot be reclassified
  - Amortised cost vs FVTSD
- Remove financial liability from records when extinguished
  - Released from the obligation, substantial modification

Subordination agreement

- It establishes the order in which debt are to be repaid in the event of foreclosure or bankruptcy
- In practice
  - Agreements drafted to suit the needs of the parties involved
  - Agreements are customised
- Consider
  - What is the trigger event? For example, liquidation triggers the subordination
  - Does interest accrue? Does it accrue after the trigger event?
  - Are contractual payments due? Or is no payment of interest and principal permitted so long as a certain condition exists.

Subordination agreement

Example

- Entity B lends R100,000 to Entity A. The loan is repayable in 5 annual instalments, and interest is charged at 10%.
- Entity A classifies the loan as a financial liability.
- At the end of year-2 Entity A and B signs a subordination agreement.
  - No payments are made until Entity A's assets exceed its liabilities. Management estimates this will be after four years from the date of the agreement.
  - Interest stops and will start to accrue when the assets exceed the liabilities. Interest will accrue at 10%.
  - Repayment will be over 5 years and start after the assets exceed the liabilities.

Subordination agreement

Example

Questions	Considerations
Must the loan liability be derecognised?	The balance due was not cancelled, waived and neither did it expire. Are the new terms substantially different from the original terms? • Entity B has no right to claim payment until an uncertain future event occurs. • Entity A has no obligation to pay until an uncertain future event occurs. • The remaining term has increased from 3 years to an estimated 9 years (4 years to recover the ratio + 5 years repayment after that) • The present value of the new terms are 32% more than the discounted of the original remaining cash flows.

Subordination agreement

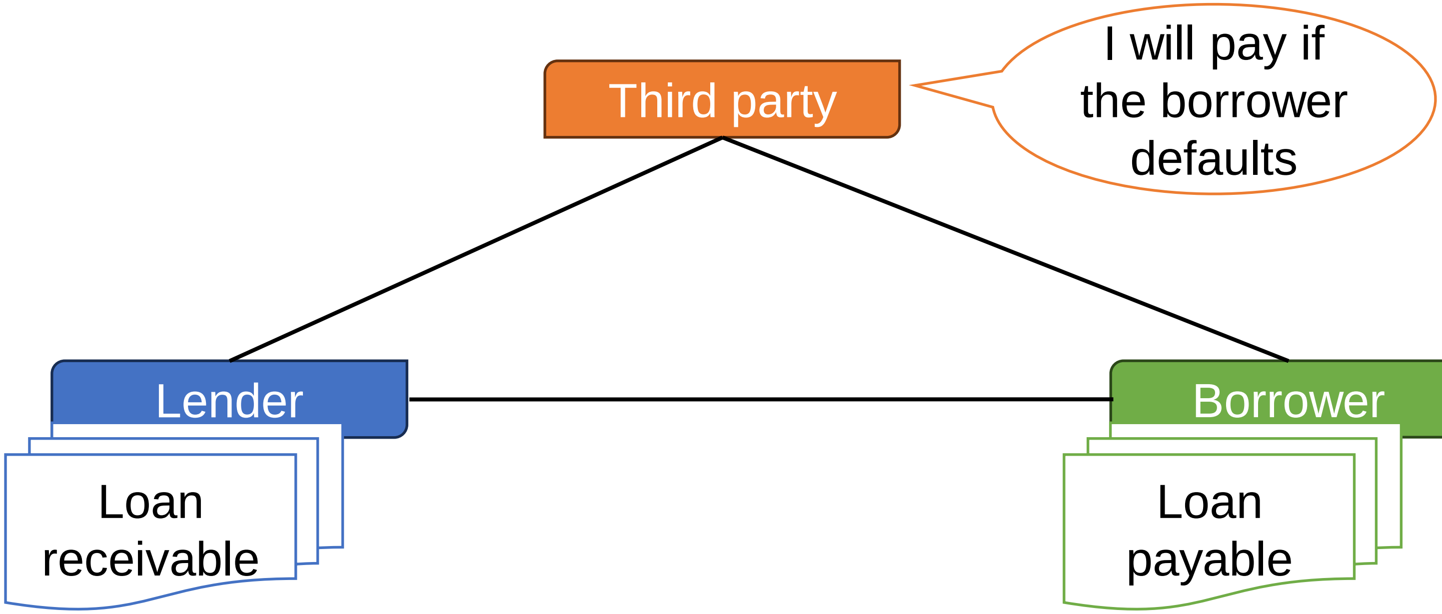
Example

Questions	Considerations
Must the loan liability be derecognised?	The terms have changed substantially as the variance of 10% or more. The loan must be derecognised.
Must Entity A recognise a liability or a residual interest based on the new terms?	• Does Entity A have a contractual obligation to pay cash? • Can Entity A avoid repaying the balance due? No. • The lack of funds or insufficient reserves does not take away the obligation that Entity A has. • Consider if the terms do not give rise to a contingent settlement provision, if so, is it genuine? Entity A must recognise a financial liability.

Letters of guarantee

Letters of guarantee

- Agreement by a third party to pay to the lender if the borrower defaults on a payment or obligation to the lender
- Will discuss in the financial guarantee session



Impairment considerations

Impairment considerations

- General approach of simplified approach?
- Simplified approach can only be used for:
  - Receivables and lease receivables
  - Receivables can be inter-entity receivables
- Loans receivable will always be the general approach
- 12-month versus lifetime expected credit losses?
  - Credit management practices must be applied to inter-entity balances
  - Is there a significant increase in credit risk?
  - Collateral, subordination agreements or letters of guarantee do not automatically equal low credit risk (par.AG5.81)

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