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MFRS Hot Topics

Loan commitments

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue discusses about accounting for loan commitments that are outside the scope of MFRS 139.

This Hot Topic provides guidance on accounting for loan commitments that are outside the scope of MFRS 139. Specifically:

- are loan commitments outside the scope of MFRS 139 for both the borrower and the lender?
- are both option-type and forward-type loan commitments outside the scope of MFRS 139?
- how should loan commitments that are outside the scope of MFRS 139 be accounted for?
- what is the accounting treatment of changes in the fair value of a loan during the commitment period?

Contents

2 Guidance
3 Discussion
6 Examples

Guidance

Types of loan commitment outside the scope of MFRS 139

In our view the MFRS 139.2(h) scope exemption applies to:

- both the (potential) lender and the (potential) borrower
- both option-type commitments (i.e. contract commitments that provide an entity with an option to borrow at a future date) and forward-type commitments (i.e. contracts that oblige the parties to enter into a borrowing arrangement at a future date).

Accounting for loan commitments outside the scope of MFRS 139

Lender

For the lender, MFRS includes some specific requirements as follows:

- the commitment itself is accounted for in accordance with MFRS 137 (MFRS 139.2(h)).
  Accordingly, a provision is recorded if the commitment is or becomes onerous
- commitment fees received when it is probable that a loan will be originated are deferred and recognised as an adjustment to the loan's effective interest rate (EIR). If the commitment expires without making a loan, the commitment fee is recognised as revenue on expiry (MFRS 118.IE.14(a)(ii))
- commitment fees received when it is not probable that a loan will be originated are deferred and recognised as revenue over the commitment period (MFRS 118.IE.14(b)(ii)).

Borrower

MFRS does not include specific requirements for the borrower. In our view it is appropriate that the borrower accounts for commitments and associated fees paid in a similar manner to the lender. Accordingly:

- commitment fees paid when it is probable that a loan will be originated should be treated as a prepayment and recognised as an adjustment to the loan's EIR. If the commitment expires without making a loan, the commitment fee is recognised as an expense
- other commitment fees paid are recorded as an asset and amortised over the commitment period or on some other systematic basis
- any asset recorded in respect of commitment fees is subject to the impairment requirements of MFRS 136.

Accounting for loans made pursuant to a loan commitment

Assuming the loan will be measured on an amortised cost basis (i.e. that it will not be designated at fair value through profit or loss), our preferred approach is to record the loan at its fair value reflecting market interest rates and the borrower's credit standing at the commitment date. No gain or loss should then arise on initial recognition.

Loan date or commitment date accounting?

On 1 January X1 a bank writes an option to a company permitting the company to borrow CU1m over 5 years at 10% (a market interest rate) at that date. The loan can be drawn-down at any time in the next 12 months. On 31 December X1, the company draws the loan. At that date, market interest rates have increased to 11%. As a result, the fair value of the loan at 31 Dec X1 is estimated as CU963,000. Is the loan recorded at CU1m or CU963,000?

Our preferred approach is to record the loan at its commitment date fair value of CU1m. The alternative approach would lead to the loan being recorded at its loan date fair value of CU963,000. The difference of CU137,000 would then be an immediate gain for the company and an immediate loss for the bank.

Discussion

Many companies enter into agreements with banks and other lenders that provide an option or an obligation to borrow money at a future date. Typically a fee is paid by the potential borrower. Such agreements may provide financial flexibility, reduce liquidity risk and provide protection against future increases in borrowing costs (e.g. resulting from increases in interest rates or a deterioration in credit standing).

The terms and conditions of these agreements vary widely. Some agreements entitle a company to borrow up to a pre-specified amount over a stated period and are replenished as repayments of outstanding balances are made (a revolving credit facility). This is an example of an option-type arrangement; the company has a right to borrow but is not obliged to do so. Less commonly, an agreement might give rise to an obligation to originate a loan at a future date. Agreements sometimes fix the interest rate or margin, or specify that the rate will be set at the loan date.

Types of loan commitment outside the scope of MFRS 139

As explained above, MFRS 139.2(h) scopes out loan commitment other than those described in MFRS 139.4. However, the term loan commitment is not defined in MFRS 139 itself. This has led to questions as to which types of arrangement should be considered loan commitments for this purpose. MFRS 139.BC15 and 16 state that:

BC 15 Loan commitments are firm commitments to provide credit under pre-specified terms and conditions…….In effect, it is a written option for the potential borrower to obtain a loan at a specified rate.

BC 16 To simplify the accounting for holders and issuers of loan commitments the Board decided to exclude particular loan commitments from the scope of MFRS 139…" [emphasis added]

Taken together, these quotes indicate that the IASB intended that the MFRS 139.2(h) scope exclusion should apply to both option and non-option type commitments, and also to both the borrower and the lender.

Accounting for loan commitments outside the scope of MFRS 139

Lender

The guidance and MFRS references set out above are largely self-explanatory.

MFRS 139.9 requires that all fees or points paid that are an 'integral part of the EIR' are brought into the calculation of the EIR. MFRS 118 then provides guidance on when commitment fees received are an integral part of the EIR. Such fees received are an integral part of the EIR if it is probable that the commitment will result in a specific loan being made (MFRS 118.IE14).

Accordingly, the treatment of commitment fees depends in part on an assessment of the probability of the underlying loan being advanced. This assessment will involve some judgment for option-type commitments. For non-option type commitments, it is of course certain that a specific loan will be made so any fees paid will be an integral part of the EIR.

In practice, one of the more difficult issues (for the lender) is determining if a loan commitment is onerous (and should therefore be provided for in accordance with MFRS 137). In our view, a commitment should be regarded as onerous if:

- an immediate impairment loss would arise on origination of the loan or
- the cost of funding the loan exceeds the interest receivable on it.

An immediate impairment loss is likely to be quite rare. This would arise only if the lender does not expect the borrower to be able to repay the funds advanced.

Borrower

Borrower accounting for loan commitments that are outside MFRS 139's scope is largely not addressed in IFRS. Accordingly an entity should develop its own accounting policy to address this type of transaction. One point that is however explicit is that MFRS 139.9 requires that the borrower (as well as the lender) includes fees that are an integral part of the EIR in the calculation of the EIR. In the absence of further specific guidance as to how to assess whether commitment fees are an integral part of the EIR, it seems appropriate to use the guidance applicable to the lender in MFRS 118.

Some commentators question whether it is appropriate to recognise an asset in respect of commitment fees paid if draw-down is not probable. These commentators note that the International Accounting Standard Board Framework's definition of an asset is met only if it is expected that future economic benefits will flow to the entity. Moreover, the Framework indicates that assets are recognised only if it is probable that the future economic benefits will flow to the entity. These arguments might be used to support an accounting policy of immediate expensing of 'non-probable' commitment fees.

Despite these arguments, our preferred view is that a right to borrow is an asset that should be recognised in the financial statements. This view is supported by:

- taking a broader view of economic benefits. The economic benefit of a right to borrow is not restricted to the loan itself (the receipt of which would not typically increase the entity's net assets).
- Rather, it is the financial security, flexibility and reduction in liquidity, market and credit risk conferred by the right analogy to the generally accepted accounting treatment for similar transactions such as prepaid insurance premiums
- virtue of the fact that a right to borrow meets the definition of a financial asset (even though it is scoped out of MFRS 139)

- recording the associated expense in a similar manner to the recognition of revenue by the lender.

If an asset is recorded for fees paid that are not integral to the EIR, this asset should be amortised on a systematic basis. In practice, straight-line amortisation over the commitment period may be a reasonable approach in many cases. However, the amortisation policy needs to reflect the terms of the commitment.

If the fees paid were not considered an integral part of the EIR at the commitment date and a loan is originated, the unamortised portion of any asset recognised should not be included in the calculation of the EIR. If the right to borrow expires once the loan is originated, the asset should be expensed at that point.

An asset recorded in relation to a loan commitment may become impaired. Examples of factors that could indicate impairment include:

- a reduction in the holder's (ie the potential borrower's) funding needs as a result of securing alternative sources of finance
- a change in future investment plans
- a significant decline in market interest rates.

Accounting for loans made pursuant to a loan commitment

If a loan commitment specifies a fixed interest rate or margin, the fair value of the underlying loan might change between the commitment date and the date of the loan. This change might reflect movements in market interest rates and/or the borrower's credit standing. If the loan is recognised initially at its fair value on the loan date (in accordance with MFRS 139.43), an immediate gain or loss would then arise. Alternatively, the loan might be recorded at a fair value reflecting market interest rates and the borrower's credit standing at the commitment date.

This is a difficult issue on which MFRS 139 appears to give conflicting guidance. MFRS 139.43 would seem to require fair value on the loan date (adjusted for applicable transaction costs) with a consequent immediate gain or loss on draw-down. Such an approach seems however to conflict with the IASB's objective in excluding many loan commitments from MFRS 139's scope. The IASB explains that the effect of this scope out is that changes in the fair value of applicable loan commitments are not recognised or measured (MFRS 139.BC16). Recognising an immediate gain or loss is equivalent to recognising this same fair value movement (albeit on a deferred basis).

Our preferred approach, partly on the grounds of simplicity, is to recognise the loan at its fair value reflecting market interest rates and the borrower's credit standing at the commitment date. This can be described as a 'commitment date' approach. However, the alternative 'loan date' approach can also be justified.

The practical importance of this issue is reduced somewhat by the fact that many loan commitments include conditions that entitle the bank to cancel the commitment if the borrower's credit standing declines significantly.

Examples

Revolving credit facility

An entity enters into a revolving credit facility on 1 January X1. The facility entitles the entity (subject to various covenants and conditions) to borrow up to CU10m on a revolving basis over the next five years at the London Inter-Bank Offered Rate (LIBOR) plus 3%. The entity pays an upfront fee of CU100,000. The stated interest rate is a market interest rate for the entity in question, without taking the commitment fee into consideration. The intention is to draw down only if working capital needs increase above expectations or other sources of finance are not available. Accordingly, management does not consider that it is probable that the loan will be drawn down.

Analysis

In this case it is not probable that a specific loan will be originated. Moreover, the fact that the specified borrowing rate is on market terms indicates that the fees paid/received are not an integral part of the EIR. Accordingly, the borrower should record the CU100,000 as an asset and amortise this amount over the 5-year term. The pattern of amortisation should reflect the manner in which the economic benefits are consumed. In this case, because the right to borrow does not expire on draw-down there is no need to accelerate the amortisation if some or all of the facility is drawn down. If the availability facility was reduced on each drawdown, the amortisation pattern should reflect this.

If the borrower took the alternative view that the right to the loan does not qualify for recognition as an asset in accordance with IFRS, the entire fee paid is expensed immediately.

The lender records the CU100,000 received as deferred revenue on 1 January X1 and releases this amount to income over the 5-year commitment period.

If it is considered probable that the loan will be drawn down, both the borrower and the lender would defer the commitment fee until the drawdown date. This amount would be brought into the calculation of the EIR at that date.

Fixed loan commitment

An entity enters into an arrangement with a bank on 1 January X1 that obliges it to borrow and the bank to lend CU1m on 31 December X1, repayable on 31 December X6. An upfront fee of CU50,000 is paid to the bank. The loan carries a fixed interest rate of 10%. This is a market interest rate for the entity in question taking into consideration the upfront fee. The 10% rate reflects market conditions and the entity's credit rating at 1 Jan X1. No other fees are incurred.

During 20X1, market interest rates decline such that the entity could have borrowed at 9.5% at 31 Dec X1.

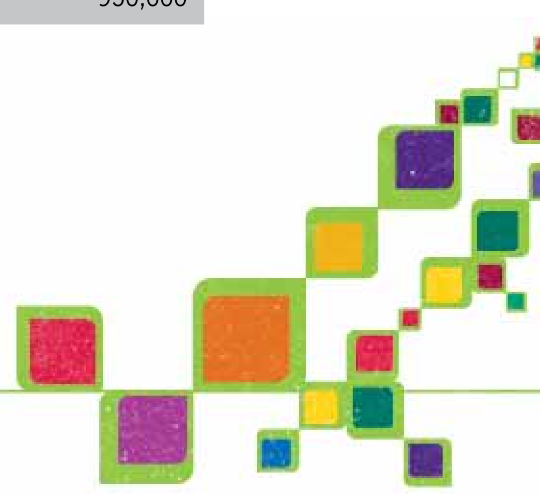
Analysis

In this case the CU50,000 appears to be an integral part of the EIR. The loan is certain and the interest rate on the loan is 'at market' only when the CU50,000 fee is considered. Accordingly, the fee is deferred as an asset by the borrower and as deferred income by the lender. No amortisation is recorded during the period. On origination of the loan, the fee is included in the EIR calculation and deducted in arriving at the loan's initial carrying amount (assuming the loan is to be measured at amortised cost using the effective interest method).

Based on our preferred commitment date accounting approach, the initial carrying amount of the loan is based on market conditions at the commitment date. Accordingly, the initial carrying value is not adjusted for the decline in interest rates over the commitment period.

From the borrower's perspective, the accounting entries on the commitment date and loan date are as follows:

Borrower accounting - 1 Jan X1 (commitment date)	Debit	Credit
Prepaid borrowing fee - asset	50,000	
Cash		50,000
Borrower accounting - 31 Dec X1 (loan date)	**Debit**	**Credit**
Cash	1,000,000	
Prepaid borrowing fee - asset		50,000
Financial liability		950,000



KUALA LUMPUR

Level 11, Sheraton Imperial Court
Jalan Sultan Ismail
50774 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

PENANG

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828
E info.pg@my.gt.com

KUANTAN

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126
E info.ktn@my.gt.com

JOHOR BAHRU

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 11848
F +607 224 9848
E info.jb@my.gt.com

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