



Clarity in financial reporting

Measurement of expected credit losses for intercompany loan assets with no documented contractual term

Introduction

The purpose of this publication

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Talking points

- Entities need to determine the substance of the transfer of funds between entities in a group. In a set of separate financial statements, the nature of the transfer will determine if it is a capital contribution, deemed distribution or a loan in the scope of AASB 9 *Financial Instruments*.
- For intercompany loans receivable with no stated terms, the lender also needs to consider the classification and measurement criteria in AASB 9 to determine if the criteria for amortised cost are met. In particular, the contractual cash flow characteristics and the business model test.
- For intercompany loan receivables with no stated terms and classified as measured at amortised cost or fair value through other comprehensive income, the lender needs to measure the expected credit loss under AASB 9's impairment requirements considering the probability of default and the loss given default.
- Intercompany loans repayable on demand with zero contractual interest rates have a nil effective interest rate.

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Introduction

In consolidated financial statements, intercompany loans eliminate. Hence, there is no intercompany loan asset in consolidated financial statements that requires a classification and expected credit loss assessment. However, when entities prepare their separate financial statements these intercompany positions do not eliminate and the reporting entity that is a lender needs to assess any intercompany loan assets for classification and potentially measurement of expected credit losses under AASB 9.

In this publication, we focus on how to assess the expected credit loss of an intercompany loan asset with no stated terms in separate financial statements.



What is an intercompany loan asset with no stated terms?

Intergroup funding arrangements can take various forms. Sometimes they are formal contractual lending agreements. However, often they are not formal contractual agreements, are interest-free and have no stated maturity. Laws and regulations of different jurisdictions could influence the treatment of such 'informal' arrangements. However, for the purpose of this publication we have considered the intercompany loan with no stated terms to be repayable on-demand. Because the arrangement has no set maturity date, the lender can demand repayment at any time from the borrower and the borrower has no right to defer or avoid repayment if the lender demanded it.

Parent entities and subsidiaries are often comfortable lending without formal contractual agreements because of the control relationship that exists between them. Parent and subsidiaries do not always need formal contractual agreements as the parent entity can unilaterally instruct the subsidiary to lend, repay or transfer funds under a shareholder's agreement.



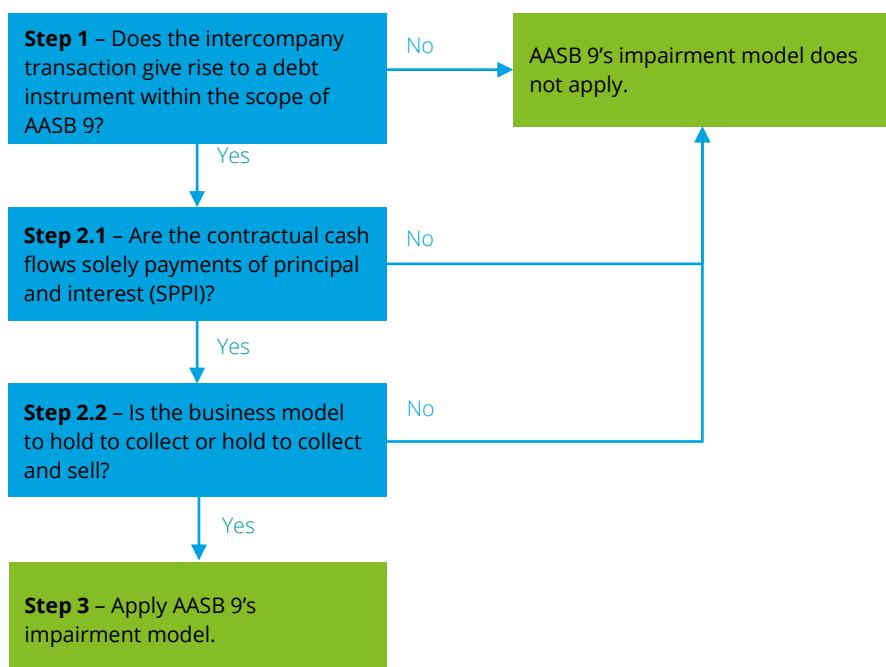
Consider improving documentation around intercompany funding transactions

Entities may want to consider the need to document their arrangements. Such documentation may be important for tax purposes and meeting the requirements in company law around keeping proper books and records.

One solution could be to enter into formal documented loan agreements. Another solution could be to document the nature of amounts transferred in minutes of board meetings and to maintain a register of such transactions. Such a register can capture any agreements (verbal or otherwise) between the related parties with regard to unconditional rights to avoid repayments or not as the case may be. Any entries (i.e. additional loans or repayments of loans) could require board approval by the parent entity and subsidiary as evidence of the arrangements and balances.

The purpose of this publication

This publication provides guidance in determining the substance of intercompany transactions and the assessment of an expected credit loss when applicable. The diagram below illustrates the structure of the assessment outlined in this publication.



For associates and joint ventures, the Australian Accounting Standards Board (AASB) issued an amendment to AASB 128 *Investments in Associates and Joint Ventures* in December 2017, effective for reporting periods on or after 1 January 2019, that clarifies that AASB 9, including its impairment requirements, applies to loans that form part of the long-term investment in that associate or joint venture but that are not accounted for using equity method. AASB 128 has guidance specific to how impairments under AASB 9 and equity accounted balances interact. This publication does not address loans with associates and joint ventures. However, for the avoidance of doubt, the impairment requirements in AASB 9 are applicable to any loan balances receivable from a joint venture or associate in the same way as for any other loan balance receivable.

Step 1 – Does the intercompany transaction give rise to a debt instrument within the scope of AASB 9?

A reporting entity should consider all facts and circumstances to determine the true nature of a transaction when there are no formal contractual terms that underpin a transaction between two entities in the same group. For example, a parent might intend for funds it transferred to a subsidiary to be a contribution rather than a loan for which it expects repayment.

How can a reporting entity determine if the nature of the intercompany transaction is a contribution or a loan? Typically, a transaction whereby a parent transfers funds to a subsidiary is a capital contribution (i.e. not a loan in the scope of AASB 9) if, for example according to minutes of meetings, the subsidiary is not required to repay the amount (i.e. the subsidiary has an unconditional right to avoid repayment).

When a reporting entity assesses the nature of the transaction (i.e. whether it is a contribution or a loan) the following considerations could be helpful in clarifying the nature of the transaction in absence of formal agreements:

- What was documented in minutes of meetings and what is the mutual understanding of both entities?
- How have the transferred funds been declared for tax purposes (i.e. as loans or contributions)?
- Have similar transactions in the past resulted in the transferor of funds demanding repayment?
- How have these balances been presented in prior year financials that have been approved by the directors?



Example – The scope of intercompany transactions with no stated terms

Parent A transfers CU100,000 to Subsidiary B on 1 January 20X0, without a formal contract between Parent A and Subsidiary B. There are no documented terms such as an interest rate or a repayment date in any formal loan agreement. However, the minutes of the meeting of Parent's A board of directors indicate that the amount is expected to be repaid at some future date.

In Parent A's separate financial statements, is the loan a financial instrument in the scope of AASB 9 or is it part of its investment in Subsidiary B in the scope of AASB 127 Separate Financial Statements?

AASB 9.2.1(a) states that AASB 9 is not applicable to financial instruments that are an interest in a subsidiary accounted for in accordance with AASB 127. AASB 127.10 only applies to investments in subsidiaries that reflect an existing ownership interest (or in-substance existing ownership interest) in the subsidiary. On the basis that owners are defined in AASB 101.7 as holders of instruments classified as equity (which is also consistent with the definition in AASB 3.Appendix A), an ownership interest must be classified as equity in the subsidiary.

In this specific example, because Subsidiary B does not have an unconditional right to avoid repayment to Parent A the instrument does not meet the definition of equity in AASB 132 for Subsidiary B but rather represents a financial liability. Therefore, Parent A should not consider this instrument to form part of an 'interest in a subsidiary' in the scope of AASB 127. Instead, the loan is a financial asset in the scope of AASB 9.

How would the assessment differ if a subsidiary transfers funds to its parent?

The parent is not always the lender in intercompany loans between a parent and a subsidiary. It could happen that a subsidiary lends money to its parent entity. In such instances, entities need to perform a similar assessment as described above. For example, if the parent entity has an unconditional right to avoid repayment to the subsidiary, the instrument may be akin to a distribution from the subsidiary to the parent (i.e. similar to a dividend distribution). However, if the parent does not have an unconditional right to avoid repayment to the subsidiary, this may indicate that the transfer gives rise to a debt instrument such that the subsidiary recognises a financial asset within the scope of AASB 9.

Distributions from subsidiaries to parent entities may be subject to legal requirements (for example, entities may need to meet specific liquidity or solvency tests for a distribution to be legal). When this is the case, the documentation required by law for the transactions may help to identify the nature of a transaction where a subsidiary transfers funds to a parent and whether it is a dividend distribution or a financial asset within the scope of AASB 9 for the subsidiary.



Thinking it through – Is the guidance in AASB 121 The Effects of Changes in Foreign Exchange Rates on “monetary items that form part of the net investment in a foreign operation” relevant in determining the nature of the intercompany transaction?

The short answer is no. The guidance in AASB 121 with regard to monetary items that form part of the net investment in a foreign operation is an area that often causes confusion in determining whether an intercompany transaction is a loan (i.e. within scope of AASB 9) or part of the investment in a subsidiary (i.e. within scope of AASB 127). The guidance in AASB 121 clarifies that an entity may have a monetary item that is receivable from, or payable to, a foreign operation (i.e. an intercompany loan). It goes on to say that an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, part of the entity's net investment in that foreign operation. However, this guidance relates only to the determination of how to recognise foreign currency translation gains or losses. This guidance is not relevant in the assessment of whether an intercompany balance is within the scope of AASB 9 or not.

Step 2.1 – Do intercompany loan assets with no stated terms meet the contractual cash flow characteristics test in AASB 9?

One of the requirements in AASB 9 to classify a financial asset at amortised cost or fair value through other comprehensive income is that its contractual terms must give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.

In the absence of a stated repayment date and stated interest rates, is it possible for an intercompany loan asset to meet the SPPI criteria? The example below illustrates the application of the contractual cash flow characteristics test for the purposes of classification and measurement.



Example – Intercompany loan assets with no stated terms and SPPI

Parent A provides a CU100,000 loan to Subsidiary B on 1 January 20X0. The loan is made without a formal loan agreement and there are no documented terms (i.e. no interest rate and no maturity date). However, Parent A may demand repayment at CU100,000 at any time. In the separate financial statements of Parent A, the loan is accounted for as a financial asset in the scope of AASB 9.

Do intercompany loan assets with no stated terms meet the contractual cash flow characteristics test in AASB 9?

Yes. For a loan to pass the contractual cash flow characteristics test, AASB 9.B4.1.7 requires that the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding (SPPI). The principal is the fair value of the financial asset at initial recognition. Interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. AASB 9.B4.1.7A states that contractual cash flows that meet SPPI requirements are consistent with basic lending arrangements. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. For intercompany loans that can be called by the lender (Parent A) at any time, the consideration for time value of money and credit risk is wholly insignificant as the loan can be called without notice (i.e. immediately after the cash is advanced). Therefore, the interest a market participant would charge for such a loan that it could call at any time would be negligible. However, irrespective of the significance of time value of money and credit risk, as there are no terms that introduce exposure to risks or volatility that are unrelated to a basic lending arrangement, intercompany loans with no stated terms (i.e. repayable on demand at the amount advanced) meet the contractual cash flow characteristics test in AASB 9. The amortised cost of the intercompany loan for both Parent A and Subsidiary B is the amount payable on demand, which is equal to its fair value at initial recognition given the amount advanced is equal to the demand amount.

Step 2.2 – Is the business model to hold to collect or hold to collect and sell?

The impairment model in AASB 9 is applicable only to the extent that a debt instrument is measured at amortised cost or fair value through other comprehensive income. In step 2.1 above we considered the contractual cash flow characteristics of the loan which is required for classification as a loan measured at amortised cost or fair value through other comprehensive income. In this step we consider the second requirement which is the business model. Under AASB 9, a debt instrument is measured at amortised cost if it is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows. Alternatively, it is measured at fair value through other comprehensive income if it is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. Any other business model will result in the debt instrument being measured at fair value through profit or loss, in which case the impairment requirements of AASB 9 do not apply.

Step 3 – Measuring the expected credit loss on an intercompany loan asset with no stated terms

AASB 9 has a general approach for impairment that distinguishes between '12-month expected credit losses' and 'lifetime expected credit losses'. Determining whether the loss allowance should reflect the 12-month expected credit losses or lifetime expected credit losses depends on whether there has been a significant increase in credit risk of the financial instrument since initial recognition (or the commitment date). The expected credit losses are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is 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.

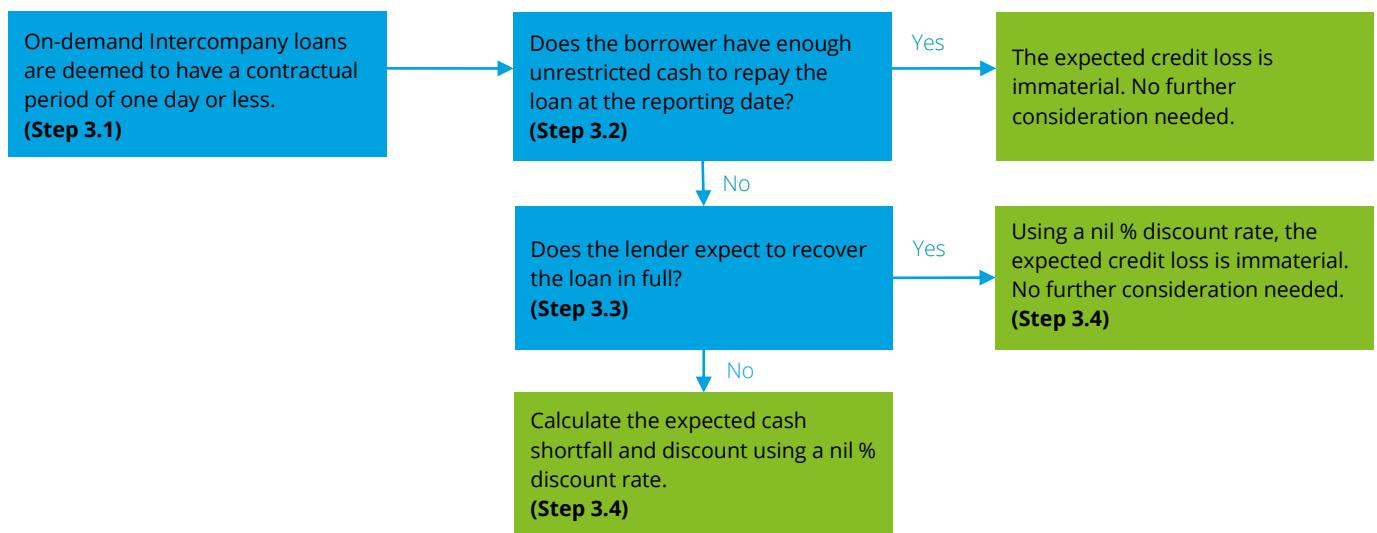


Appendix – the theory behind AASB 9's general approach to impairment

The appendix to this publication contains a summary of the principles supporting AASB 9's impairment model. For more detail on how the approach works and detail on certain concepts used in this section of the publication, please refer to the appendix.

Putting the theory into practice, expected credit losses under the 'general approach' can best be described using the following formula: Probability of Default (PD) x Loss given Default (LGD) x Exposure at Default (EAD). Applying this formula to measuring an expected credit loss for an intercompany loan with no stated terms, the following steps should be considered:

- Step 3.1 – What is the period to consider when measuring the expected credit loss?
- Step 3.2 – What is the probability of default (PD) over that period (i.e. the period determined in step 3.1)?
- Step 3.3 – What is the loss given default (LGD) for that PD (i.e. the PD determined in step 3.2)
- Step 3.4 – What discount rate should be used when calculating the expected credit losses?



Step 3.1 – What period should be considered when measuring the expected credit loss of an intercompany loan repayable on demand?

AASB 9.5.5.19 states that the maximum period to consider when measuring expected credit losses is the maximum contractual period over which the entity is exposed to credit risk and not a longer period. Because the parent may demand repayment with as little as one day's notice, the maximum period in accordance with AASB 9.5.5.19 is one day or less.

It is worth noting that AASB 9.5.5.20 allows a loss allowance to be measured over a period longer than the contractual period if the financial instrument has both a loan and an undrawn commitment component. In the case of an intercompany repayable on demand, there is no loan commitment and therefore, AASB 9.5.5.20 does not apply.

Consequently, for intercompany loans with no stated terms and assumed to be repayable on demand, there is no distinction between 12-month and lifetime expected credit losses from a measurement point of view. This is because the lender's credit exposure is essentially limited to the time it takes to demand repayment (i.e. as short as one day or less).

Step 3.2 – What is the probability of default (PD)?

Given that the period of measurement is one day or less, this short term nature of the calculation results in one of two outcomes. Either the borrower can repay on demand or it cannot.

If at the reporting date, the borrower has the capacity to repay the loan if demanded by the lender (i.e. the borrower has sufficient cash resources without restrictions to repay with one day's notice), the expected credit loss allowance will be negligible. In other words, the PD would be close to nil and the expected credit loss would be immaterial. However, if at the reporting date, the borrower would be incapable of repaying the loan in full if demanded by the lender with one day's notice, the probability of default would likely be very high. In other words, the PD would be close to 100%.

Step 3.3 – What is the loss given default (LGD) when the borrower is not capable of repaying on demand?

Even though the probability of default may be close to 100%, in establishing the loss given default, the lender would consider what actions the borrower could undertake to meet the contractual demanded amount and so mitigate the credit losses suffered by the lender. In other words, the lender should consider the expected manner of recovery and recovery period of the cash flows due under the intercompany loan if called.

For example:

- the borrower may not have sufficient cash resources to repay the loan immediately, but may be capable of paying the loan through disposal of other non-cash assets, if provided additional time. The lender would need to consider the net realisable value (including the cost of disposal) of these assets and whether it is expected to cover the outstanding balance. Or, alternatively;
- the borrower could continue trading and pay excess cash flows to the lender over an extended period until the outstanding amount is repaid. In such instances, cash flow forecasts might help to give an indication of the trading cash flows expected to be generated over the extended period. It is worth noting that the recovery period may not necessarily be short.

Regardless whether assets are being sold or excess cash flows are being used to repay the outstanding balance, the cash flow forecasts need to incorporate relevant and reliable forward-looking information that is probability weighted. It is worth noting that the recovery period of cash flows is different from the contractual period of the instrument for the purposes of determining the probability of default. In other words, a PD is based on the contract life (which is nil for loans with no stated repayment terms), but the LGD is based on the period the entity ultimately expects to recover the cash flows.

Step 3.4 – What discount rate should be used when calculating the expected credit losses?

The loss given default reflects the amount and timeliness of the cash recovered through repayment of the loan. AASB 9.B5.5.44 requires that expected credit losses be discounted to the reporting date using the effective interest rate (EIR) at initial recognition or an approximation thereof. For loans with no stated repayment terms, the EIR is nil %.

The consequence of a nil % EIR is that if all recovery scenarios indicate that the full amount of the loan will be recovered, there will be no impairment loss to recognise. In other words, even if the recovery period is not short (i.e. the time it takes to dispose of assets or the time it takes to repay the loan from excess trading cash flows), an EIR of nil % would not give raise to credit losses due to time value.



Thinking it through

On initial recognition, the fair value of a financial liability with demand features is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. In the case of an intercompany loan repayable on demand, the fair value would equal the face value of the loan (i.e. the undiscounted amount repayable). The financial asset would be measured on the same basis.

The EIR for a financial asset is defined in Appendix A of AASB 9 as the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.

Using the example of an on-demand loan of CU100,000, the fair value measurement at initial recognition of the loan is CU100,000. The EIR calculation is based on the point in time that repayment is expected which, in this example, will be longer than the maximum contractual period of repayable on demand. However, only an EIR of nil % discounts the future expected repayment of the loan of CU100,000 to the initial gross carrying amount of the loan of CU100,000.

AASB 9.B5.1.1 states that the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market interest rate(s) of interest for a similar instrument with a similar credit rating. However, the guidance in AASB 9.B5.1.1 relates to the determination of fair value for long term instruments with no stated interest payments (for example, a 5-year interest-free loan). Consequently, the requirement in AASB 9.B5.1.1 is not relevant for loans that are "at-call" (or repayable on-demand).

Conclusion

In the separate financial statements of an entity, AASB 9 applies to intercompany receivables. However, when such arrangements have no stated terms it may be challenging to apply the impairment requirements of AASB 9. In this publication we discussed what entities should consider in assessing whether an intercompany balance is in scope of AASB 9, how to classify it for measurement purposes and how to go about determining the expected credit loss allowance.

For intercompany loans with no terms, entities should also take note of the consequence of certain aspects discussed in this publication. More specifically, the consequences of a nil % EIR. For example, in circumstances where an entity expects a full recovery of a loan (under all forward looking scenarios), but it will take time to collect the cash flows upon default, there is no credit loss for time value lost. In other words, if an intercompany loan was to default and it took a year to recover the full amount, there is no credit loss due to time value as the cash flows recovered in a year will be discounted at nil %.

On the other hand, if an entity does not expect a full recovery of a loan but expects to recover only 50% of the loan over the next year (for example), there is no discounting of the cash short falls due the nil % EIR. Consequently, any short falls will be recorded as nominal amounts and not in present value terms.

Also of note is the impact of time value on measurement of intercompany loans with terms (for example repayable in two years) compared to loans with no terms. For example, a parent entity might have two intercompany loan receivables of CU100,000 each from the same subsidiary. Loan A has a term of two years. Loan B has no terms (deemed to be on-demand). Assume that in the event of default it would take the parent three years to recover all cash flows through the sale of assets and trading for both loans. Loan A would be discounted using an EIR other than nil and an impairment would be recorded that reflects the time value. However, Loan B would record no loss as a result of not reflecting time value (as discussed above).

It is therefore important for entities to carefully consider the accounting implications of different intercompany loan balances and how they may differ, which in turn may impact how entities within the group choose to fund themselves. Entities should carefully consider disclosures around impairment of intercompany loan receivables with no terms to explain the expected losses and provide context around the impact of using a nil % EIR.

Appendix – the theory behind AASB 9's general approach to impairment

Under AASB 9's 'general approach', a loss allowance for lifetime expected credit losses is recognised for a financial instrument if there has been a significant increase in credit risk (measured using the lifetime probability of default) since initial recognition of the financial asset. If, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, a loss allowance for 12-month expected credit losses is recognised. In other words, the 'general approach' has two bases on which to measure expected credit losses; 12-month expected credit losses and lifetime expected credit losses.



What is meant by 12-month expected credit losses and lifetime expected credit losses?

Lifetime expected credit loss is the expected credit losses that result from all possible default events over the expected life of a financial instrument.

12-Month expected credit loss is the portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. The term '12-month expected credit losses' might intuitively sound like a provision for the cash shortfalls that an entity expects in the next 12 months. This is not the case. AASB 9 explains that 12-month expected credit losses are a portion of the lifetime expected credit losses and represent the lifetime cash shortfalls that will result from those possible default events that may occur in the 12 months after the reporting date.

The term 'default' is not defined in AASB 9 and an entity will have to establish its own policy for what it considers a default, and apply a definition consistent with that used for internal credit risk management purposes for the relevant financial instrument. This should consider qualitative indicators (e.g. financial covenants, unlikelihood to pay factors) when appropriate. AASB 9 includes a rebuttable presumption that a default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes should be applied consistently to all financial instruments unless information becomes available that demonstrates that another default definition is more appropriate for a particular financial instrument.

When it comes to the actual measurement under the 'general approach' an entity should measure expected credit losses of a financial instrument in a way that reflects the principles of measurement set out in AASB 9. These dictate that the estimate of expected credit losses should reflect:

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- the time value of money; and
- reasonable and supportable information about past events, current conditions and forecasts of future economic conditions that is available without undue cost or effort at the reporting date.

When measuring expected credit losses, an entity need not necessarily identify every possible forward looking scenario. However, it should consider the risk or probability that a credit loss occurs by reflecting 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. It is also worth noting that the credit loss outcomes of scenarios are not necessarily linear. In other words, an increase in unemployment of 1% could have a greater negative impact on credit risk than a reduction of 1% in unemployment would have on a positive impact of credit risk.



What is a PD, LGD and EAD?

Probability of Default (PD) is an estimate of the likelihood of a default over a given time horizon. For example, a 20% PD implies that there is a 20% probability that the loan will default. (AASB 9 makes a distinction between 12-month PD and a lifetime PD as described above).

Loss given Default (LGD) is the amount that would be lost in the event of a default. For example, a 70% LGD implies that if a default happens only 70% of the balance at the point of default will be lost and the remaining 30% may be recovered (be that through recovery of security or cash collection).

Exposure at Default (EAD) is the expected outstanding balance of the receivable at the point of default.

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