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RELATED ENTITY LOANS

SCCB Contract 0702055 - Provision of Financial Assessment Services

Exposure to Related Parties

One of the most common areas of concern raised in financial assessments involves related entity loans.

Where an entity makes a loan to a related party, there is a presumption that the entity expects:

- i) that the related party will repay the loans, and
- ii) that the related party has the financial capacity to repay such loans.

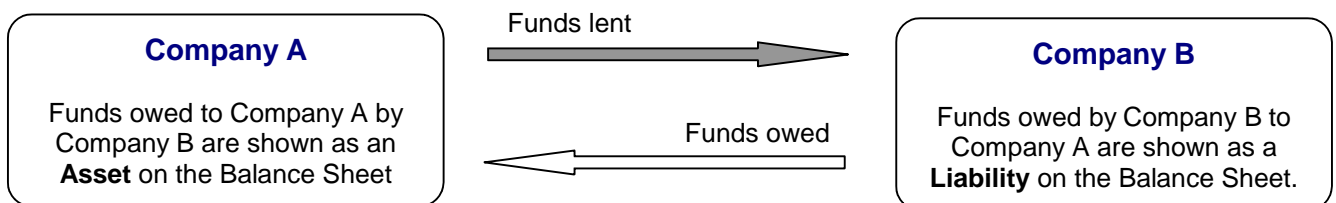
Related party loans may be current or non-current and related parties can be parties such as associated companies, group companies, directors and shareholders.

When related party loans make up a substantial proportion of an entity's current or non-current assets, this may lead to a high degree of financial interdependency between the entity and its related parties. Repayment of these loans become dependent upon the financial capacity of the related parties which are indebted to the entity.

The existence of related entity loans may therefore present a risk to the financial capacity of the entity itself.

Where the financial statements of the entity are audited and the audit report does not contain any qualifications with respect to the loans, the risk posed is greatly reduced.

As per the diagram below, if a related party (Company B) does not have the capacity to repay its loans to the entity (Company A), Company A's financial capacity may deteriorate, and has the potential to result in Company A not being able to meet its financial obligations as and when they become due and payable.



What can you do to mitigate risk?

- i) Where it has been noted that the amount attributable to related party loans is material, to the extent that failure to repay the loans would result in significant changes to its financial position, it would be worthwhile to conduct an additional financial assessment on the related party (or parties) to obtain further assurance of their ability to repay the amount owed.
- ii) It is also prudent to obtain assurance in the form of a written statement from the entity's management regarding the related entity's ability and willingness to repay the loan as and when required. Additional assessments and written statements would provide a greater level of comfort about the entity's ability to manage its financial resources without the possibility of running out of funds due to them being tied up in unrecoverable loans.
- iii) If you are concerned about related entity loans identified in a report, feel free to contact Kingsway to discuss your options.