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A&A Accounting Technical

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Clarity in financial reporting

Long-term interests in equity accounted investees

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Talking points

- The IASB has clarified that long-term interests in equity accounted investees that in substance form part of an entity's net investment in the equity accounted investee fall within the scope of AASB 9 *Financial Instruments* (AASB 9) and must be tested for impairment using an expected credit loss model applying a new three-step approach ('the 2017 amendment'). These interests would include items such as preference shares and long-term loans (interest-bearing or interest-free) for which settlement is neither planned nor likely to occur in the foreseeable future. Prior to this amendment there was diversity in practice, thus application of the amendment will increase consistency albeit at the expense of complexity
- Entities will need to determine and disclose what interests it has classified as 'long-term interests'. Furthermore, these interests need to be appropriately classified, measured, tested for impairment and disclosed in accordance with AASB 9 and AASB 7 *Financial Instruments: Disclosures* (AASB 7)
- Under the new three-step approach, long-term interests are first tested for impairment under AASB 9, ignoring prior years' equity method loss absorption, before true up of past loss allocations and booking the current year equity share/loss. Entities are also required to track unallocated losses
- Companies that finance their investments in loss-making/potentially loss-making equity accounted investees using loans or preference shares will be most impacted by the amendment. In our experience this is commonly found in the real estate, construction and extractive industries sectors
- Entities need to also consider adjustments arising from the adoption of AASB 15 *Revenue from Contracts with Customers* (AASB 15), AASB 9 and AASB 16 *Leases* in the accounts of the equity accounted investee as they will flow through into the equity accounted investment carrying value, retained earnings and equity accounted profit/loss allocation of the investor
- AASB 9 and AASB 15 are effective for years commencing on or after 1 January 2018, i.e. for 31 December 2018 and 30 June 2019 year ends. The amendment is effective for annual periods beginning or after 1 January 2019 with earlier application permitted.

Background

There was uncertainty in practice about whether AASB 9, in particular its new expected credit loss (ECL) impairment requirements, applies to an entity's long-term interests in an equity accounted investee to which the equity method is not applied but that form part of the entity's net investment in the investee. Furthermore, it was unclear as to how the impairment requirements of AASB 9 interrelated with the equity accounted loss absorption requirements of AASB 128 *Investments in Associates and Joint Ventures* (AASB 128) especially when the equity interest has been reduced to nil. The amendment applies to long-term interests in both associates and joint ventures.

The amendment

The amendment introduces a three-step approach as to how the impairment requirements under AASB 9 interrelate with equity accounted loss absorption under AASB 128 for those long-term interests in the scope of AASB 9. It clarifies that loans advanced to an equity accounted investee, which in substance form part of the net investment but to which the equity method is not applied, must first be tested for impairment by applying the ECL model in AASB 9. Thereafter, AASB 128.38 is applied to determine the equity accounted loss absorption that should be allocated to the net investment. Following on from that, AASB 128 paragraphs 40-43 are applied to determine whether there is any further impairment loss on the net investment using the 'incurred loss model', i.e. there must be objective evidence of impairment.

The three-step approach for long-term interests in the scope of AASB 9 is outlined below:

Apply AASB 9 independently

- AASB 9 impairment model is applied ignoring any prior year AASB 128 loss absorption.

True up past allocations

- The change in the AASB 9 carrying value may necessitate the true-up of prior years AASB 128 loss allocation in the current year. This may require recognising more prior year losses, reversing these losses or reallocating them between different long-term interest instruments.

Book current year equity share

- Allocate any current year AASB 128 losses to the extent that the remaining long-term interest balance allows. Any current year AASB 128 profits first reverse any unrecognised prior year losses and are then allocated against the long-term interests. This will result in the reversal of any prior year loss absorbtions before increasing any long-term interests.

The requirement to first test for impairment under AASB 9 and then true-up past loss allocations results in impairment losses, determined in accordance with AASB 9, being disclosed where previously they may not have been disclosed. For example, prior to this amendment it is possible that a loan loss allowance was not recognised on the basis that the loan was fully written off as a result of prior years' loss absorption allocations. Applying the amendment, the expected credit loss allowance of AASB 9 would be recognised ignoring past equity method loss absorptions and potentially necessitating a true-up as the recognition of the loss allowance may result in the loan balance being negative. Entities are required to provide adequate disclosure reconciling the long-term interest balance and related loss allowance under AASB 7, giving particular attention to how any true-ups are presented as no specific guidance is provided in this regard. For example, entities will need to determine whether to include the true-up as part of the loan impairment loss or as part of the equity profit pick up. Other presentations may also be appropriate but in all cases adequate disclosure should be provided in regards to the true-up to ensure the financial statements are not misleading.

If the equity accounted investee subsequently reports profits, the investor resumes recognising its share of profits only after the share of the profits equals the share of the losses not recognised. Accordingly, entities are required to track unallocated losses and any true ups which will impact the unallocated losses. Refer to the practical example in the Appendix at the end of this publication which illustrates this point and provides example disclosures.

Effective date

AASB 9 and AASB 15 are effective for years commencing on or after 1 January 2018.

AASB 16 and the amendment is effective for annual periods beginning on or after 1 January 2019. Earlier application is permitted. This enable entities to apply the amendment with the implementation of AASB 9 if they wish to but leaves other entities additional implementation time.

The amendments are to be applied retrospectively in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* however, there are transition requirements similar to those of AASB 9 for entities that apply the amendments after they first apply AASB 9.

If an entity does not restate prior periods, at the date of initial application of the amendment it shall recognise in the opening retained earnings (or other component of equity, as appropriate) any difference between:

(a) The previous carrying amount of long-term interests at that date; and
(b) The carrying amount of those long-term interests at that date.

Other considerations

Impact of adoption of new accounting standards

The adoption of AASB 9, AASB 15 and AASB 16 may have a knock on impact on the related loan loss absorption. This is because any adjustments in the accounts of the equity accounted investee arising on adoption of new accounting standards will have an impact on the equity accounted profit/loss allocation and the investment in the equity accounted investee carrying value in the accounts of the investor. For example, if adoption of new accounting standards results in a once off transition adjustment in the accounts of the equity accounted investee this will have an impact on the investment in equity accounted investee's carrying value in the accounts of the investor with a corresponding adjustment to opening retained earnings. Furthermore, the ongoing impact of the adoption of new accounting standards may impact the ultimate equity profit/loss allocation for the investor.

Consistency of accounting policies between equity accounted investee and the investor

Entities are required to use uniform accounting policies when determining the appropriate equity accounted allocation. On adoption of AASB 9, AASB 15 and AASB 16 many accounting policy choices exist, for example the transition approach adopted, challenges may arise when the equity accounted investee has elected a different transition approach to the investor as adjustments will be required to the extent to which the impact is material.

What is a long-term interest?

AASB 128.38 requires equity accounted losses to be allocated to the net investment in the equity accounted investee in reverse order of their seniority (i.e. priority in liquidation). The net investment in the equity accounted investee comprises the carrying amount of the investment in equity accounted investee using the equity method, plus any long-term interests that in substance form part of the entity's net investment in the equity accounted investee. Furthermore, under AASB 121 *The Effects of Changes in Foreign Exchange Rates*, foreign exchange differences on monetary long-term interests that form part of the net investment in the equity accounted investee are recognised in other comprehensive income while foreign exchange differences on other types of intercompany monetary loans are recognised in profit and loss.

For these reasons, entities will need to distinguish between those interests that form part of the net investment in the equity accounted investee referred to as long-term interests and those that do not. Entities have different funding structures and different reasons for why certain types of loans are used. In certain instances it may be clear that the loan should be classified as a long-term interest and form part of the net investment. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture and should be classified as such. Such items may include preference shares and long-term receivables or loans, but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans.

Judgement will need to be applied in determining what items should be classified as long-term interests and entities should provide appropriate disclosure of which amounts make up the entities net investment in the equity accounted investee.

Application of AASB 9 measurement and classification requirements to long-term interests

AASB 9 introduces new measurement and classification requirements for financial assets. Entities will need to apply these requirements when determining how to appropriately classify the long-term interest. For a more detailed discussion on the classification requirements of AASB 9 please refer to **IFRS 9: Financial Instruments - high level summary.**

Application of AASB 9 expected credit loss model to long-term interests

AASB 139 *Financial Instruments: Recognition and Measurement*, the previous guidance for assessing impairment of financial assets, had an incurred loss model, where losses were recognised when there was objective evidence of impairment. Under AASB 9, lenders of intercompany loans will be required to consider forward-looking information to calculate ECL's, regardless of whether there has been an impairment trigger. This process may be challenging for entities. Depending on the terms of the loan agreement, the measurement of the ECL under AASB 9 could prove a challenge in itself. For example, sometimes these loans have no stated terms or maturity date. In such cases, additional layers of judgement and estimates are required to measure the ECL. Please refer to the **Applying the expected credit loss model to trade receivables using a provision matrix** publication for further guidance on applying the ECL approach.

Actions

Below is a list of 5 key actions you need to take now:

1. Determine what adjustments, if any, are required in the equity accounted investee's accounts on adoption of AASB 9, 15 & 16 and the related impact on the investment in equity accounted investee carrying value and equity profit/loss allocation
2. Ensure the equity accounted investee applies accounting policies that are similar to those of the investor to the extent to which it has a material impact
3. Appropriately determine and classify all long-term interests and provide adequate disclosure in the financial statements
4. Test all long-term interests recognised at amortised cost for impairment under AASB 9 using the expected credit loss model applying the new three-step approach. Ensure unallocated losses are appropriately tracked
5. Appropriately communicate and disclose the impact of new accounting standards and the amendment to key stakeholders.

Appendix – Practical example

Fact pattern:

- Ordinary shares representing a 40% ownership interest to which the investor applies the equity method
- Long-term loan that forms part of the net investment in the associate that the investor measured at amortised cost applying AASB 9.

The long-term loan is not an originated credit-impaired loan. Throughout the years illustrated, there is no objective evidence that the net investment in the associate is impaired applying AASB 128, nor is the long-term loan credit-impaired applying AASB 9. For the purposes of this example interest on the long-term loan has been ignored.

The investors' initial investment in ordinary shares is $100, and $55 in the long-term loan with an expected credit loss of $5 on day one. On acquisition of the investment, the cost of the investment equals the investors' share of the net fair value of the associates identifiable assets and liabilities.

	Long-term loan applying AASB 9 (amortised cost)	40% share of annual profit /(loss) of the associate
Initial recognition	$50	
Year 1	$40	($140)
Year 2	$30	($100)
Year 3	$50	$150

Initial recognition:		
Dr. Investment in associate	$100	
Dr. Long-term loan	$55	
Cr. Bank		$155
To recognise the initial investment and long-term loan in the associate		
Dr. Impairment loss (P/L)	$5	
Cr. Loss allowance – Long-term loan		$5
To recognise the day one loss allowance on the loan at first reporting period		

Summary initial recognition positions:

Description	Carrying amount
Loan	$50 ($55-$5)
Investment in associate	$100

End of year 1:		
Dr. Impairment loss (P/L)	$10	
Cr. Loss allowance – Long-term loan		$10
To recognise an increase in the loss allowance ($40-$50)		
Dr. Share of loss of associate (P/L)	$100	
Cr. Investment in associate		$100
To recognise the investors share of the associates loss ($140) limited to the carrying value of the investment ($100)		
Dr. Share of loss of associate (P/L)	$40	
Cr. Loss allowance – Long-term loan		$40
To recognise investors share of the associates loss $40		

Summary of end of year 1 position:

Description	Carrying amount
Loan	$0
Investment in associate	$0
Unallocated loss	$0

Year 1 Reconciliation of movements:

	Expected credit loss allowance	Share of losses allocated to loan	Loan balance net of ECL allowance and loss allocation	Investment in associate
Beginning of Year			$55	$100
Recognition of day one ECL	($5)		($5)	
Recognition of Y1 ECL	($10)		($10)	
Share of loss of associate		($40)	($40)	($100)
Closing Balance	($15)	($40)	$0	$0

End of year 2:		
Dr. Impairment loss (P/L)	$10	
Cr. Loss allowance – Long-term loan		$10
To recognise an increase in the loss allowance ($30-$40)		
Dr. Loss allowance – Long-term loan	$10	
Cr. Share of profit of associate (P/L) [1]		$10
To recognise the true up of prior year loss allocation to the net value of 0		

Summary of end of year 2 position:

Description	Carrying amount
Loan	$0
Investment in associate	$0
Unallocated loss	$110 ($100 plus $10 true up)

Year 2 Reconciliation of movements:

	Expected credit loss allowance	Share of losses allocated to loan	Loan balance net of ECL allowance and loss allocation	Investment in associate
Beginning of Year	($15)	($40)	$0	$0
Recognition of Y2 ECL	($10)		($10)	
True up in terms of AASB 128		$10	$10	
Closing Balance	($25)	($30)	$0	$0

End year 3:		
Dr. Loss allowance – Long-term loan	$20	
Cr. Impairment loss (P/L)		$20
To recognise a decrease in the loss allowance ($50-$30)		

[1] Please note that for the purposes of this example it was assumed that the true-up would go against the share of profit of associate line item on the basis that the true-up is different in nature to an impairment loss. However, it should be noted that other treatments may be appropriate depending on the specific facts and circumstances and significance of the balance. Adequate disclosure should be provided in the accounts in relation to this balance.

End year 3:		
Dr. Loss allowance – Long-term loan	$30	
Cr. Share of profit in associate (P/L)		$30
To reverse prior years losses allocated to the loan		
Dr. Investment in associate	$10	
Cr. Share of profit in associate (P/L)		$10
To recognise the investors share of the associates profit of $150 after taking into account previously unallocated losses of $110 and reversal of previous losses against the loan of $30 i.e. $150-$110-$30 = $10		

Summary of end of year 3 position:

Description	Carrying amount
Loan	$50
Investment in associate	$10
Unallocated loss	0

Year 3 Reconciliation of movements:

	Expected credit loss allowance	Share of losses allocated to loan	Loan balance net of ECL allowance and loss allocation	Investment in associate
Beginning of Year	($25)	($30)	$0	$0
Recognition of change in ECL for Y3	$20		$20	
Prior year unrecognised share of loss of associate				($110)
Share of profit from associate less amount allocated to the loan				$120 ($150-30)
Reversal of share of loss after unallocated loss fully absorbed		$30	$30	
Closing Balance	($5)	$0	$50	$10

For a detailed example from the IASB relating to this amendment please refer to **www.ifrs.org**

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