

STAFF PAPER

November 2015

IFRS Interpretations Committee Meeting

Project	IFRS 9 <i>Financial Instruments</i> and IAS 28 <i>Investments in Associates and Joint Ventures</i> —Measurement of long-term interests		
Paper topic	Measurement of interests in associates and joint ventures that, in substance, form part of the net investment		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

Introduction

1. The IFRS Interpretations Committee (‘the Interpretations Committee’) received a request related to the interaction between IFRS 9 *Financial Instruments* and IAS 28 *Investments in Associates and Joint Ventures*. Specifically, the issue relates to whether the measurement of long-term interests in associates and joint ventures that form part of the ‘net investment’ (‘the long-term interest’), in particular relating to impairment, should be governed by IFRS 9, IAS 28 or a combination of both.
2. At its meeting in September 2015, the Interpretations Committee discussed this issue,¹ and noted that:
 - (a) the feedback received from the outreach had indicated that there were divergent views on how to account for the impairment of long-term interests and that the issue was widespread; and
 - (b) the interaction between the requirements of IFRS 9 and IAS 28 in relation to this issue was unclear.

¹ For details, see [Agenda Paper 10](#) for the Interpretations Committee’s meeting in September 2015.

3. Consequently, the Interpretations Committee considered that an amendment to IFRS would be required in order to clarify the issue; in particular, the interaction between the requirements in IFRS 9 and IAS 28 within the context of the long-term interests.
4. The objective of this agenda paper is to provide the Interpretations Committee with a summary of the staff analysis, along with the staff recommendation.
5. This paper provides:
 - (a) a summary of informal comments from the IASB members;
 - (b) staff analysis; and
 - (c) staff recommendation.

Informal feedback from the IASB members

6. Subsequent to the Interpretations Committee's discussion in September 2015, we consulted the IASB members at various meetings in October 2015 to inform them of the discussion held by the Interpretations Committee and to obtain their individual views on this issue. We did not ask the IASB members to make any decisions when we consulted them.
7. The followings are a summary of their informal comments:
 - (a) Some members thought that the current wording of IAS 28 and IFRS 9 would lead to View D.²
 - (b) A few members thought that if the IASB were to amend the Standard(s), other Views should also be analysed, including whether the long-term interests should be excluded from the IFRS 9 impairment requirements.

² Views identified in the submission and discussed by the Interpretations Committee at its meeting September 2015 are as follows:

- (a) View A—Entirely in the scope of IFRS 9 (subject to an IAS 28.38 loss allocation);
- (b) View B—Entirely in the scope of IFRS 9 (subject to an IAS 28.38 loss allocation) and also in the scope of IAS 28/36 for impairment;
- (c) View C—Entirely in the scope of IAS 28; and
- (d) View D—In the scope of IFRS 9 for classification and measurement, excluding IFRS 9 impairment (subject to an IAS 28.38 loss allocation).

- (c) A few members expressed a preference for View B over View D. Under both Views, the long-term interests are subject to allocation of losses and the impairment requirements in IAS 28. The difference between these Views would be that under View B the long-term interests would be subject to all aspects of the IFRS 9 requirements, including the impairment, while under View D the impairment requirements in IFRS 9 would not apply to such long-term interests,
- (d) Some members thought that the IASB should not propose an amendment in the short term. Instead, they thought that this issue should be referred to the Equity Method of Accounting research project ('the Research Project'), and should be considered together with the broader question of what the equity method is. They were concerned that if this was addressed separately, there could be different amendments to IAS 28 at different timings, which would create a burden on preparers.
- (e) In contrast, some members were of the view that the IASB should provide a clarification through a narrow-scope amendment. This is because they thought that anything that would come out of the Research Project could take many years, and would not be timely enough to address the concern raised.
- (f) A few members thought that it would be useful to understand what are included in the 'net investment' in practice. If there are many instances in which the net investment includes financial instruments that are measured at fair value in accordance with IFRS 9, the analysis should not be limited to financial instruments that are measured at amortised cost.

Staff analysis

8. This section is divided into the following sub-sections:

- (a) the Interpretations Committee's discussion in September 2015;

- (b) possible solution to deal with the interaction between the requirements in IAS 28 and IFRS 9 that arises from View D;
- (c) an alternative to View D; and
- (d) financial instruments that are measured at fair value.

The Interpretations Committee’s discussion in September 2015

9. When the Interpretations Committee discussed this issue at its meeting in September 2015, there was a fair amount of support for View D.
10. If View D were followed, accounting consequences would be:
 - (a) The long-term interests are accounted for in accordance with IFRS 9 except for the assessment and measurement for impairments.
 - (b) As part of the net investment, the long-term interests are subject to allocation of share of losses of an investee.³
 - (c) As part of the net investment, the long-term interests are assessed for impairments, using the indicators that are included in IAS 28.⁴ If there is any objective evidence that the net investment is impaired, the impairment is measured using the requirements in IAS 36 *Impairment of Assets*.
11. In the light of these accounting consequences, the Interpretations Committee noted that if View D were to be pursued as a clarification, it would have to understand how the interaction would work between the requirements in IAS 28 (ie allocation of losses/impairments) and the requirements in IFRS 9 (ie recognition of interest income).
12. Consequently, the Interpretations Committee directed the staff to consider the interaction of these Standards, in determining an appropriate amendment.

³ Allocation of losses applies to the long-term interests to the extent that the allocation exceeds an entity’s investment in ordinary shares of the investee.

⁴ The indicators included in IAS 28 are largely the same as the incurred loss impairment indicators that were previously contained in IAS 39 *Financial Instruments: Recognition and Measurement*. Currently, IAS 28 refers to IAS 39 for impairment indicators.

A possible solution to deal with the interaction between IAS 28 and IFRS 9 requirements that arises from View D⁵

13. We understand that the Interpretations Committee’s support for View D was on the basis of the current wording in IAS 28 and IFRS 9, and not necessarily on the basis of which View would produce the most useful information. We also understand that the Interpretations Committee’s support for an amendment based on View D is conditional on whether the interaction would work between the IAS 28 and IFRS 9 requirements under that view.

What’s causing an issue?

14. A tension in this interaction arises because the expected credit loss impairment model in IFRS 9 is part of and interlinked with the amortised cost accounting in IFRS 9. More specifically in accordance with IFRS 9:

- (a) measurement of interest income and impairment both use:
 - (i) contractual cash flows associated with financial instruments; and
 - (ii) an original effective interest rate.
- (b) an amortised cost of a financial asset reflects, among other things, any adjustments for any loss allowance; and
- (c) for financial assets other than purchased or originated credit-impaired financial assets, interest income is calculated on the basis of the gross carrying amount until the financial instruments become credit impaired at which stage interest income is calculated on the basis of the amortised cost.

15. In contrast, inputs used in IAS 36 for measuring impairments are different from those in IFRS 9:

⁵ The analysis included in this section assumes that the long-term interests included in the ‘net investment’ meets the criteria for classification as amortised cost financial instruments in accordance with IFRS 9. Considerations of financial instruments measured at fair value are included in paragraphs 56–60.

- (a) the recoverable amount is used as an amount to be compared with the carrying amount of an asset, which is the higher of the fair value less costs of disposal and value in use; and
 - (b) if value in use is used, the discount rate could be a risk-free rate if the risk is reflected in cash flows.
16. Similarly, the amount of allocation of equity method losses under IAS 28 is not based on the inputs used for measurement under IFRS 9.
17. As summarised in paragraphs 14–16, the measurement model, including impairment, is different between IAS 28/IAS 36 and IFRS 9. Consequently, we are of the view that it would be difficult, if indeed it proved to be possible at all, to find a perfect reconciliation between these two Standards.

A possible proposal

18. We have come up with a possible proposal to deal with the interaction issue that arises from View D.
19. Under this proposal, an entity would:
- (a) treat any cumulative impairment or loss allocations under IAS 28 as an allowance against the long-term interest. In other words, the allocated losses and/or impairments do not affect the carrying value of the long-term interest for the purpose of recognition of interest income; and
 - (b) use the original effective interest rate on the gross carrying amount of the long-term interest for amortised cost accounting (ie recognition of interest income) under IFRS 9 (similar to Stage 2 impairment under IFRS 9).
20. Following this model, an entity would be able to retain the IFRS 9 requirements intact with respect to the recognition of interest income, except for the use of the base carrying amount (ie gross basis or net basis).

Is there a better alternative than View D?⁵

21. We note that if an amendment were to be proposed, instead of an interpretation, it would not need to be limited to an interpretation of what the current Standards say. In this regard, in analysing other alternatives, we considered the following:
- (a) how to make an amendment;
 - (b) scope of the ‘net investment’, and equity method accounting;
 - (c) application of IFRS 9 impairment requirements to the long-term interest;
 - (d) interaction of the requirements in IAS 28 and IFRS 9 under an alternative view; and
 - (e) what Standard(s) to amend;

How to make an amendment

22. Considering that this issue partly relates to accounting requirements of IAS 28 and that the Research Project is in progress, there are two possible ways to address an issue; that is, either through:
- (a) a narrow-scope amendment; or
 - (b) the Research Project.
23. As noted in paragraph 7, some IASB members thought that this issue should be referred to the Research Project, while other IASB members thought that this issue should be addressed through a separate narrow-scope amendment.
24. Potential benefits associated with addressing this issue through the Research Project could include:
- (a) Any amendment in relation to this issue that would come out of the Research Project could be based on, and therefore be consistent with, any new revised objectives in relation to the equity method of accounting.
 - (b) There would be fewer burdens on stakeholders, especially on preparers, because amendments relating to IAS 28 that would come out of the Research Project would be published at the same time.

Consequently, the amendments would have the same effective dates, which might not be the case if the amendments were published separately at different times.

25. Despite these potential benefits, we are of the view that the issue should be addressed through a narrow-scope amendment. This is because we think that:
- (a) it is important that a clarification should be made with respect to this issue before IFRS 9 becomes effective, which is in 2018; and
 - (b) any amendment that would come out of the Research Project could take many years.
26. We think that a clarification should be made before IFRS 9 becomes effective because without a clarification, we think that there would be diversity in which any of the Views A–D would be applied and that this could have significant financial impacts.
27. With respect to items included in the Research Project, we are aware that the area of impairment of associates is being considered in the Research Project in the short term, but there is currently no plan to address the issue with a short-term amendment. Consequently, we think that anything that would come out of the Research Project would not be likely to be published before IFRS 9 becomes effective.
28. On the basis of this analysis, we recommend that an amendment should be pursued through a narrow-scope amendment.

Scope of the ‘net investment’, and equity method accounting

29. We note that the issue originally arose mainly because the long-term interest is included in the ‘net investment’ for the purpose of allocation of losses and impairment under IAS 28. In other words, if the long-term interests had not been included in the ‘net investment’, this issue would not have arisen.
30. We think that an amendment could consider the broader question of whether the long-term interests should stay in the ‘net investment’, and/or whether the long-term interests should be included in the population of financial instruments that are accounted for using the equity method.

31. However, we think that these broader considerations should not be pursued through a narrow-scope amendment, because they touch on fundamental aspects of the equity method of accounting. We think that a broader question like this is better placed in the Research Project.
32. As we recommended in the previous section, we think that an amendment should be made through a narrow-scope amendment. Consequently, we are of the view that the amendment should not consider possible changes to the composition of the ‘net investment’ and/or financial instruments that are accounted for using the equity method.

Should the long-term interest be excluded from the IFRS 9 impairment?

33. Under View D, the impairment requirements in IFRS 9 do not apply to the long-term interest. But is this appropriate?
34. We note that the benefits of the new impairment model in IFRS 9 include the fact that it is:
- (a) a more forward-looking model that requires entities to consider a wide range of information. Consequently, it is more responsive to changes in credit risk and responds to concerns raised during the financial crisis about the delayed recognition of losses under the IAS 39 impairment model; and
 - (b) a single impairment model for all the financial instruments to which the impairment requirements apply, which reduces complexity of multiple impairment models which existed under IAS 39.
35. We note that the only difference between the long-term interests in the ‘net investment’ and other financial instruments that are within the scope of IFRS 9 is that the former is included within the scope for the purpose of allocation of losses and impairments under IAS 28. We are of the view that this difference alone is not sufficient to justify exclusion of the long-term interests from the IFRS 9 impairment requirements, because the allocation of

losses and impairments under IAS 28 cannot be a substitute for the impairment requirements in IFRS 9.

36. First, IFRS 9 switched the impairment model from the incurred loss model to the expected credit loss model, but allocation of losses and assessment for impairments under IAS 28 is generally based on the incurred loss model.
37. Second, we think that the requirements relating to allocation of losses and impairments under IAS 28 are not designed to override measurement requirements that are included in other Standards. Instead, we think that they are merely a mechanism to ensure that sufficient losses are recognised with respect to the interests in the associates.
38. With respect to the second point above, we understand that the revisions to IAS 28 in 2003 expanded the scope of financial interests that are subject to the allocation of losses and impairment under IAS 28 to include the long-term interests because of a concern relating to structuring opportunities for investors. In this regard, paragraphs BCZ 39–40 of IAS 28 state:

BCZ39 The Board decided that the base to be reduced to zero should be broader than residual equity interests and should also include other non-equity interests that are in substance part of the net investment in the associate or joint venture, such as long-term receivables. Therefore, the Board decided to withdraw SIC-20.

BCZ40 The Board also noted that if non-equity investments are not included in the base to be reduced to zero, an entity could restructure its investment to fund the majority in non-equity investments to avoid recognising the losses of the associate or joint venture under the equity method.

39. We understand from this that:
 - (a) the long-term interests are included in the ‘net investment’ so as to ensure that entities would recognise adequate losses that are allocable

to the entities' investment in the associate, and only for that purpose;
and

- (b) consequently, the long-term interests should be accounted for in all respects, including impairment, in accordance with the applicable Standard, which in this case is IFRS 9.

40. On the basis of the analysis, we are of the view that allocation of losses and impairments under IAS 28, which occurs only once the loss occurs, cannot be a substitute for the impairment requirements in IFRS 9, which adopts the expected credit loss model. Consequently, we are of the view that the IFRS 9 impairment requirements should apply to the long-term interests.

Interaction of the requirements in IAS 28 and IFRS 9 under an alternative view

41. On the basis of our conclusions in the previous sections, an alternative view would be consistent with View B. Under this View, accounting consequences would be:

- (a) the long-term interests are accounted for in accordance with IFRS 9 in their entirety, including the impairment requirements.
- (b) as part of the net investment, the long-term interests are subject to allocation of share of losses of an investee; and
- (c) as part of the net investment, the long-term interests are assessed for impairment using the indicators that are included in IAS 28.

42. We understand that this alternative also creates interaction considerations between the requirements in IAS 28 and IFRS 9, because the long-term interest is within the scope of both Standards for (a part of) the measurement requirements.

43. Because under this view the long-term interests are accounted for in their entirety in accordance with IFRS 9, the logical steps would be:

- (a) first, account for the long-term interests in accordance with IFRS 9, including the impairment; and

- (b) second, bring into the amount of the ‘net investment’ the carrying value of the long-term interests reflecting the impairment recognised under IFRS 9, if any.
44. If there is any allocation of losses and/or impairments under IAS 28 to the long-term interest, entities would treat those losses and/or impairments as an allowance, so that they do not affect the carrying amount of the long-term interests for the measurement purposes of IFRS 9.
45. We are of the view that the interaction under this alternative works better than the one under View D, because the requirements in IFRS 9 are kept intact, which means that the benefits of IFRS 9 are retained.
46. We are aware that under this alternative view the long-term interests are subject to two different methods of impairment testing. Some may argue that application of impairment requirements in different Standards to the same item is counterintuitive. However, we understand that this is not the case with respect to the issue, because these impairment requirements under IAS 28 and IFRS 9 apply to different units of account:
- (a) under IFRS 9, the unit of account is the long-term interest; and
- (b) under IAS 28, the unit of account is the ‘net investment’, which includes the long-term interest.
47. We note that this different layer of impairment testing would be necessary with respect to the long-term interests merely to ensure that entities record adequate losses and impairments in relation to their investments in the associate.
48. In addition, we note that a similar situation to this already exists in other Standards. For example:
- (a) Under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, non-current assets that are not within the measurement requirements of that Standard are first measured in accordance with applicable Standards, including the impairment requirements. Then, the carrying amount of those non-current assets become part of a

disposal group, which is measured at the lower of its fair value less costs of disposal and its carrying value.

- (b) Under IAS 36, assets that constitute the cash-generating unit to which goodwill has been allocated should be tested for impairment before the unit containing the goodwill is tested for impairment, if they are tested for impairment at the same time.

49. On the basis of this analysis, we are of the view that:

- (a) the interaction between the requirements of IAS 28 and IFRS 9 under the alternative view would work better than the one under View D; and
- (b) two layers of impairment testing with respect to the long-term interest themselves are not an issue, and instead they are consistent with the measurement objective of both IAS 28 and IFRS 9.

50. Consequently, we recommend pursuing the alternative view, instead of View D.

What Standard(s) to amend

51. We note that an amendment required depends on which View to be followed.

52. We also note that the IASB should avoid amending IFRS 9, if possible, during the endorsement process of IFRS 9.

53. If the Interpretations Committee agrees with our view that the alternative view should be pursued, we think that an amendment in line with that view can be made by providing clarifications only to IAS 28. We hold this view because:

- (a) paragraph 2.1(a) of IFRS 9, read together with paragraph 14 of IAS 28, makes it clear that IFRS 9 does not apply to interests in associates and joint ventures that are accounted for using the equity method.
- (b) if it is not sufficiently clear that the long-term interests that form part of the ‘net investment’ are not included in the interests accounted for using the equity method, a clarification can be made to IAS 28.
- (c) additional guidance relating to the interaction analysed in paragraphs 41–49 can be made in IAS 28.

54. Consequently, if the Interpretations Committee agrees with the alternative view, we recommend that an amendment should be made only to IAS 28.

Summary

55. A summary of our analysis is that:
- (a) any amendment should be made through a narrow-scope amendment, instead of via the Research Project;
 - (b) an amendment should not consider possible changes to the composition of the ‘net investment’ and/or financial instruments that are accounted for using the equity method;
 - (c) the IFRS 9 impairment requirements should apply to the long-term interests;
 - (d) the interaction between the requirements in IAS 28 and IFRS 9 under the alternative view would work better than the one under View D;
 - (e) consequently, the alternative view should be pursued, instead of View D; and
 - (f) the amendment should be made only to IAS 28.

Financial instruments measured at fair value

56. Our analysis focussed on financial instruments that are measured at amortised cost. This is because it was the assumption included in the original submission and that type of financial instruments would need more clarification compared with financial instruments measured at fair value.
57. However, we are of the view that if the IASB were to provide an amendment, it should consider whether the amendment should cover guidance relating to financial instruments that are measured at fair value. This is because if there are many instances in which the ‘net investment’ includes financial instruments that are measured at fair value in accordance with IFRS 9, an amendment that covers only financial instruments measured at amortised cost cannot deal with those situations.
58. Financial instruments measured at fair value in accordance with IFRS 9 that are included in the ‘net investment’ could include :

- (a) non-interest bearing loans;
 - (b) preference shares; and
 - (c) long-term loans with a conversion feature.
59. We think that it is worthwhile to understand the types of financial instruments included in the ‘net investment’ in practice besides ordinary shares, and how they would be classified under IFRS 9, before analysing potential issues that could arise if the financial instruments were measured at fair value.
60. Consequently, we recommend that the Interpretations Committee should consider whether an amendment should also cover financial instruments measured at fair value. In making this assessment, the Interpretations Committee could perform outreach to stakeholders in order to understand the types of financial instruments included in the ‘net investment’ and how likely they are classified as other than amortised cost under IFRS 9.

Summary and staff recommendation

61. On the basis of our analysis, we recommend that the Interpretations Committee should pursue an amendment in line with the alternative view, which would result in entities:
- (a) first, accounting for the long-term interests in their entirety in accordance with IFRS 9, including the impairment requirements;
 - (b) then, applying the requirements relating to allocation of losses and impairment in accordance with IAS 28 to the ‘net investment’ that includes the long-term interest; and
 - (c) treating as an allowance any cumulative losses and impairments recognised in (b) above that are allocated to the long-term interests for the purpose of recognising interest income.
62. We also recommend that the Interpretations Committee should assess whether an amendment should cover financial instruments other than those measured at amortised cost in accordance with IFRS 9. In this regard, the Interpretations

Committee could perform outreach to stakeholders in order to understand the types of financial instruments included in the ‘net investment’ and how likely they are classified as other than amortised cost under IFRS 9.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree with the staff’s recommendation that it should pursue an amendment in line with the alternative view?
2. Does the Interpretations Committee agree with the staff’s recommendation that it should assess whether an amendment should cover financial instruments other than those measured at amortised cost in accordance with IFRS 9? If the Interpretations Committee agrees with the recommendation, it could perform outreach to stakeholders in order to understand the types of financial instruments included in the ‘net investment’ and how likely they are classified as other than amortised cost under IFRS 9.