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STAFF PAPER

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Project	**IFRS 9 *Financial Instruments* and IAS 28 *Investments in Associates and Joint Ventures*—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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Introduction

1. At its meetings in September and November 2015, the IFRS Interpretations Committee ('the Interpretations Committee') discussed an issue related to the interaction between IFRS 9 *Financial Instruments* and IAS 28 *Investments in Associates and Joint Ventures*. Specifically, the issue relates to whether an entity should apply IFRS 9, IAS 28 or a combination of both Standards to the measurement of long-term interests in an associate or a joint venture that, in substance, form part of the 'net investment' in the associate or joint venture (hereafter, referred to as 'long-term interests'). The question relates mainly to impairment.

2. At those meetings, the Interpretations Committee discussed various alternative ways that the requirements could be interpreted, noting the following:

   (a) the feedback received from outreach indicated that there are differing views on how to account for the impairment of long-term interests and that the issue is widespread;

   (b) the main difference between the alternatives is whether long-term interests are subject to the IFRS 9 impairment requirements; and

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(c) in the view of the Interpretations Committee members, the scope exception in IFRS 9 regarding interests in associates and joint ventures is not clear in this respect.

Consequently, the Interpretations Committee concluded that an amendment to IFRS Standards may be required to clarify the issue.

3. However, after discussing the issue at two meetings, the Interpretations Committee did not reach a consensus on which alternative to propose as an amendment. Consequently, the Interpretations Committee decided to consult with the International Accounting Standards Board (‘the Board’) about whether the scope exception in IFRS 9 is intended to apply to such long-term interests.

4. The Board discussed the issue at its meeting in December 2015. Board members expressed mixed views, and no conclusions were reached at that meeting. We think that at least part of the reason for mixed views was that it is unclear which types of interests are considered to be ‘long-term interests’—this is discussed in more detail in paragraphs 32-39 of this paper.

5. We thought that it would be helpful for the Interpretations Committee if the Board were to continue its discussion of the issue, specifically addressing the questions raised by the Interpretations Committee. Consequently, the purpose of this paper is:

   (a) to provide a staff analysis of the questions posed by the Interpretations Committee, focussing on the wording of the relevant requirements in IFRS Standards; and

   (b) to ask the Board whether it agrees with the staff analysis in the paper.

6. Having received this input, we then plan to report back to the Interpretations Committee so that it can consider next steps.

Summary of staff analysis

7. A summary of the staff analysis is that:

   (a) the scope exception in paragraph 2.1(a) of IFRS 9 does not apply to long-term interests in an associate or a joint venture. In other words, an entity applies the requirements of IFRS 9, including those relating to impairment, to such long-term interests to which the equity method is *not* applied;

   (b) an entity would account for long-term interests in an associate or a joint venture as follows:

      (i) the entity would classify and measure the long-term interests applying IFRS 9, including applying the impairment requirements of IFRS 9;

      (ii) in allocating any losses of the associate or joint venture, the entity would then include the carrying amount of those long-term interests (determined applying IFRS 9) as part of the net investment to which the losses are allocated; and

      (iii) the entity would assess the net investment for impairment applying the requirements in paragraphs 40-43 of IAS 28.

Structure of this paper

8. This paper is structured as follows:

   (a) background (paragraphs 9–16);

   (b) staff analysis (paragraphs 17–40); and

   (c) Appendix A—Summary of comments received at the GPF meeting in November 2015.

Background

Issue raised

9. Paragraph 2.1(a) of IFRS 9 states that interests in associates and joint ventures that are accounted for in accordance with IAS 28 are excluded from the scope of IFRS 9. Paragraph 14 of IAS 28 further explains this scope exception as follows:

> IFRS 9 *Financial Instruments* does not apply to interests in associates and joint ventures that are accounted for using the equity method. When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in an associate or a joint venture, the instruments are not subject to IFRS 9. In all other cases, instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with IFRS 9.

10. Paragraph 38 of IAS 28 requires that, when an entity is allocating losses of an associate or a joint venture to the carrying amount of its investment in that associate or joint venture, the entity should allocate losses to both:

    (a) interests that it accounts for using the equity method; and

    (b) long-term interests that, in substance, form part of the net investment.

11. In this respect, paragraph 38 states the following (emphasis added):

> If an entity's share of losses of an associate or a joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognising its share of further losses. The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method *together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture. 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*. 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. [….]

12. Paragraphs 40–43 of IAS 28 then go on to explain that this net investment is subject to impairment testing. More precisely:

    (a) an entity is first required to assess whether there is any objective evidence that the net investment is impaired by considering the indicators included in paragraphs 41A–41C of IAS 28. These indicators were largely transferred from IAS 39 *Financial Instruments: Recognition and Measurement* as part of the development of IFRS 9;

    (b) if this assessment indicates that the net investment is impaired, then the entity is required to measure impairment by applying the impairment requirements in IAS 36 *Impairment of Assets*.

13. In the light of these requirements in IFRS 9 and IAS 28, the submitter asked whether the scope exception in paragraph 2.1(a) of IFRS 9 should be interpreted to include long-term interests, in particular within the context of the impairment requirements. In other words, should an entity assess long-term interests for impairment by applying only the requirements in IAS 28, or should the entity also apply the impairment requirements in IFRS 9 to such interests?

14. The submitter is of the view that the requirements are unclear. The submitter observes that there is already diversity in practice applying IAS 39; however, this has not been perceived to be an issue because of the similarity of the impairment models in IAS 28/IAS 36 and IAS 39. With the introduction of a new expected credit loss model applying IFRS 9, the submitter thinks that the effects of the diversity is likely to be more significant.

Views identified

15. The submitter identified the following four views as to how to interpret the requirements:

    (a) View A—long-term interests in an associate or a joint venture are entirely within the scope of IFRS 9 (and are subject to the loss allocation requirements in paragraph 38 of IAS 28);

    (b) View B—these long-term interests are entirely within the scope of IFRS 9 (and are subject to the loss allocation requirements in paragraph 38 of IAS 28). In addition, these interests are also subject to the impairment requirements in paragraphs 40-43 of IAS 28;

    (c) View C—these long-term interests are entirely within the scope of IAS 28, and are not within the scope of IFRS 9; and

    (d) View D—these long-term interests are within the scope of IFRS 9 for classification and measurement purposes, excluding impairment (and are subject to the loss allocation requirements in paragraph 38 of IAS 28). In addition, these interests are also subject to the impairment requirements in paragraphs 40-43 of IAS 28.

The Interpretations Committee's questions for the Board

16. The Interpretations Committee considered that it would be helpful in deciding upon next steps if the Board were able to clarify the following:

    (a) whether the scope exception in paragraph 2.1(a) of IFRS 9 applies to long-term interests in an associate or a joint venture; and

    (b) if not, how the requirements of IFRS 9 and IAS 28 interact with respect to these long-term interests.

Staff analysis

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

    (a) applicability of the scope exception of paragraph 2.1(a) of IFRS 9 to long-term interests;

    (b) accounting for long-term interests; and

    (c) clarification of the type of interests that are included in the net investment in an associate or a joint venture.

Does the scope exception in IFRS 9 apply to long-term interests?

18. On the basis of the wording of the requirements in IFRS 9 and IAS 28, we are of the view that the requirements of IFRS 9, including those relating to impairment, apply to long-term interests in an associate or a joint venture to which the equity method is not applied. In other words, in our view, the scope exception in paragraph 2.1(a) of IFRS 9 does not apply to such long-term interests. We hold this view because we think that:

    (a) the scope exception in paragraph 2.1(a) of IFRS 9 applies only to interests in an associate or a joint venture that an entity accounts for using the equity method (refer to paragraphs 19-22 of this paper); and

    (b) interests, described as long-term interests in IAS 28, are not accounted for using the equity method (refer to paragraphs 23-25 of this paper).

The scope exception applies only to interests that an entity accounts for using the equity method

19. Paragraph 2.1(a) of IFRS 9 states the following:

    > 2.1 This Standard shall be applied by all entities to all types of financial instruments except:
    >
    > (a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IFRS 10 *Consolidated Financial Statements*, IAS 27

> *Separate Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures.* […]

20. We understand that, on the basis of this paragraph alone, some consider that it is unclear as to which types of interests the scope exception applies; ie they think that it is unclear whether the scope exception applies only to interests in associates and joint ventures that an entity accounts for using the equity method, or whether it also applies to interests to which some aspects of the requirements of IAS 28 apply.

21. However, paragraph 14 of IAS 28 clarifies that the scope exception in IFRS 9 applies only to interests in an associate and a joint venture that an entity accounts for using the equity method. Paragraph 14 of IAS 28 states:

> 14 IFRS 9 *Financial Instruments* does not apply to interests in associates and joint ventures that are accounted for using the equity method. […]

22. Consequently, we are of the view that the scope exception of IFRS 9 applies only to interests in an associate and a joint venture that an entity accounts for using the equity method.

Does an entity account for long-term interests using the equity method?

23. We think that an entity does not account for interests, which IAS 28 refers to as long-term interests, using the equity method. This is because paragraph 38 of IAS 28 (set out in paragraph 10 of this paper) distinguishes between 'the investment in the associate or joint venture determined using the equity method' and 'any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture'. We understand this to mean that any long-term interests are separate from those interests to which the equity method is applied and, therefore, an entity does not account for long-term interests using the equity method.

24. Although long-term interests are subject to one part of the equity method procedures (ie the allocation of losses), we do not consider this to mean that an entity accounts for such long-term interests using the equity method. This is

because applying the equity method involves much more than just allocating losses. Paragraph 3 of IAS 28 defines the equity method as:

> a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

25. We think that this interpretation is consistent with the requirements in paragraph 38 of IAS 28, which explains that the interest in an associate or a joint venture subject to the allocation of losses is the investment accounted for using the equity method *together with* long-term interests that form part of the net investment.

Other considerations

26. We note that IFRS Standards applicable before IFRS 9 was issued included exactly the same requirements as those now included in paragraph 14 of IAS 28 and paragraph 2.1(a) of IFRS 9. Consequently, the question does not arise as a result of the issuance of IFRS 9.

27. In addition, we note that the expected credit loss impairment model in IFRS 9 is part of, and interlinked with, amortised cost accounting in IFRS 9. For example, how interest revenue is calculated depends on whether the related financial asset is credit-impaired. Consequently, it is difficult to see how amortised cost accounting in IFRS 9 would work without the application of the impairment requirements of IFRS 9. This indicates that the Board did not intend the measurement requirements of IFRS 9 to be applied in isolation of the impairment requirements.

Summary

28. On the basis of this analysis, we are of the view that the scope exception in paragraph 2.1(a) of IFRS 9 does not apply to long-term interests in an associate or a joint venture. In other words, an entity applies the requirements of IFRS 9,

including those relating to impairment, to such long-term interests to which the equity method is not applied.

Question 1—the scope exception in paragraph 2.1(a) of IFRS 9
1. Does the Board agree with the staff analysis that the scope exception in paragraph 2.1(a) of IFRS 9 does not apply to long-term interests? In other words, an entity applies the requirements of IFRS 9, including those relating to impairment, to such interests.

Accounting for long-term interests

28. On the basis of the analysis set out in the section above, an entity would account for long-term interests in an associate or a joint venture as follows:

    (a) The entity would classify and measure the long-term interests applying IFRS 9, including applying the impairment requirements of IFRS 9;

    (b) In allocating any losses of the associate or joint venture, the entity would then include the carrying amount of those long-term interests (determined applying IFRS 9) as part of the net investment to which the losses are allocated; and

    (c) The entity would assess the net investment for impairment applying the requirements in paragraphs 40-43 of IAS 28.

29. If an entity allocates losses or recognises impairment applying IAS 28 as a result of steps (b) and (c) in paragraph 28 above, in our view an entity would ignore those losses or impairment in recognising interest income on the long-term interests applying IFRS 9 in subsequent periods.

30. According to this view, long-term interests are subject to two different methods of impairment testing. However, we note that this does not mean that the same asset is tested for impairment in two different ways. This is because the unit of account is different in each case as follows:

    (a) applying IFRS 9, the unit of account is the long-term interests; and

(b) applying IAS 28, the unit of account is the 'net investment', of which any long-term interests are only a part.

31. We think that this view is consistent with the rationale for the amendment that the Board made to IAS 28 in 2003. That amendment expanded the scope of interests that are subject to the allocation of losses and impairment requirements of IAS 28 to include long-term interests. In this regard, paragraphs BCZ39–40 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.

Question 2—the accounting for long-term interests
2. Does the Board agree with the staff analysis of the accounting for long-term interests in an associate or a joint venture as summarised in paragraph 28 of this paper?

Clarification of the type of interests that are included in the net investment in an associate or a joint venture

32. At the December 2015 Board meeting, Board members expressed mixed views about the accounting for long-term interests in an associate or a joint venture. We think that at least part of the reason for mixed views was that it is unclear which types of interests are considered to be 'long-term interests'.

33. IAS 28 refers to three types of financial interests in an associate or a joint venture, as follows:

    (a) Category 1—investments in the associate or joint venture that an entity accounts for using the equity method (ie those interests to which only IAS 28 applies);

    (b) Category 2—financial interests that do not form part of the net investment in the associate or joint venture (ie those interests to which only IFRS 9 applies); and

    (c) Category 3—financial interests that form part of the net investment but to which the equity method is not applied (ie what this paper and IAS 28 refers to as long-term interests). As described in paragraph 28 of this paper, we think that both IFRS 9 and IAS 28 apply to these long-term interests.

34. IAS 28 provides little information about the types of interests within each category. Depending on the type of interest, an entity may need to apply more or less judgement in determining within which category the interests are included. For example, for investments in ordinary shares, it is likely to be relatively straight-forward to conclude that the equity method is applied to such investments, and thus that the investment is included in Category 1. Similarly, it is likely to be relatively straight-forward to conclude that trade receivables or loans with fixed repayment terms (such as a 10-year senior bond) are not part of the net investment in the associate or joint venture, and thus that those instruments are included in Category 2. However, determining those interests that are considered to be long-term interests, within Category 3, will often require more judgement.

35. Paragraph 38 of IAS 28 provides the following as an example of long-term interests:

> 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. Such items may include preference shares and long-term receivables or loans, […]

36. In some cases judgement will be required to distinguish long-term interests from either Category 1 interests or Category 2 interests, particularly when the instruments have features such as:

    (a) no fixed terms and conditions as to the repayment date or the date of interest payments; or

    (b) the amount of the financial interests that the entity has in the associate or joint venture is proportional to its ownership share.

37. Some might hold the view that such interests are, in substance, the same as an equity investment in the associate. For those that hold this view, this type of interest might be included within Category 1, and accounted for using the equity method. Alternatively, some might hold the view that such interests are not an equity investment, and thus the equity method should not apply to such interests because they do not give the investor voting rights and an ownership interest comparable to holding ordinary shares. The conclusion will depend on the particular facts and circumstances.

38. Because of this, there was a suggestion at the Board meeting in December 2015 that we should consider whether it might be helpful to develop an Interpretation to clarify the types of interests that are included in the net investment in an associate or a joint venture. This suggestion was also made by a few GPF members—see Appendix A to this paper.

39. Although we think that clarity in this respect might be helpful, we note that the submitter of this issue did not ask for this clarity. At this stage, we are not aware of whether this is an issue in practice or whether an Interpretation could be developed that would be useful. In addition, we think that any consideration of the types of interests to which the equity method should be applied would be better addressed as part of a research project on the equity method of accounting.

Next steps

40. If the Board agrees with the staff analysis, our next step would be to report the views of the Board to the Interpretations Committee at a future meeting. On

receiving clear views from the Board on whether, and how, the scope exception in paragraph 2.1(a) of IFRS 9 applies to long-term interests, we think that the Interpretations Committee could consider publishing a tentative agenda decision in line with those views.

Appendix A—Summary of comments received at the GPF meeting in November 2015

A1. At the Global Preparers Forum (GPF) in November 2015, we asked GPF members which types of financial instruments are, in their experience, included as long-term interests that, in substance, form part of the net investment in an associate or a joint venture. The following is a summary of their comments:

(a) One GPF member commented that non-interest-bearing loans that an entity intends to keep for the long term are included in the net investment, even if the terms of the loan state that it is payable on demand.

(b) A few GPF members commented that the accounting treatment of long-term interests in associates would depend on facts and circumstances. For example, one member stated that:

(i) if the entity is the only shareholder that has long-term interests in the associate, the entity would apply IFRS 9 to those interests; and

(ii) if the amount of long-term interests that the entity has is proportional to its ownership share, the entity would apply IAS 28 to the net investment as a whole, including the long-term interests.

(c) A few GPF members commented that it would be useful if IAS 28 were amended to make clearer which financial instruments qualify to be included in the net investment in an associate or a joint venture.