IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

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

CONTACT(S) Takashi Yamagami tyamagami@ifrs.org +44 (0)20 7246 6937

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 Standard do not purport to be acceptable or unacceptable application of that IFRS Standard—only the IFRS Interpretations Committee or the International Accounting Standards Board (the 'Board') 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. At its meetings in September and November 2015, the IFRS Interpretations Committee ('the Interpretations Committee') discussed an issue relating 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 applies 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, but to which the equity method is not applied (hereafter, referred to as 'long-term interests'). The question relates mainly to impairment.

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

   (a) the feedback from outreach activities 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

(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, depending on which alternative to pursue, 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 meetings in December 2015 and February 2016. The Board specifically considered the following with respect to the issue:

   (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 such long-term interests.

5. At its meeting in February 2016, the Board agreed with the staff analysis of the accounting for long-term interests applying IFRS Standards as described in paragraph 33 of this paper.

6. The purpose of this paper is to provide the Interpretations Committee with that staff analysis and a staff recommendation on the issue.

Structure of this paper

7. The paper is structured as follows:

   (a) background;

   (b) staff analysis;

   (c) assessment against the Interpretations Committee’s agenda criteria;

(d) staff conclusion and recommendation;

(e) Appendix A—Proposed wording for the tentative agenda decision;

(f) Appendix B—Summary of the Board’s discussion; and

(g) Appendix C—Additional question raised during the Board’s discussions.

Background

Issue raised

8. 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.

9. 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.

10. 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. [….]

11. Paragraphs 40 and 41A–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 applying the impairment requirements in IAS 36 *Impairment of Assets*.

12. 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, only those in IFRS 9, or a combination of the requirements in both Standards?

13. 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 a significant 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 in IFRS 9, the submitter thinks that the effects of the diversity are likely to be more significant.

Views identified

14. 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—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 and 41A-43 of IAS 28;

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

    (d) View D—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 and 41A-43 of IAS 28.

Summary of feedback received from outreach activities as reported in September 2015[1]

15. The feedback received from our outreach activities can be summarised as follows:

    (a) a majority of the respondents noted that the requirements were unclear and, thus, they thought that some or all of the views provided by the submitter were possible;

[1] For details, see Agenda Paper 10 for the Interpretations Committee's meeting in September 2015. The outreach was conducted with members of the International Forum of Accounting Standard-Setters, securities regulators, and the global IFRS technical teams of the large accounting firms.

(b) opinions were also varied regarding whether long-term interests should form part of the carrying amount of the net investment in an associate or a joint venture for the purposes of impairment applying IAS 28; and

(c) many respondents noted that they had either observed existing diversity in practice applying IAS 39 or expect it to arise in the future upon application of IFRS 9.

Staff analysis[2]

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

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

(b) accounting for long-term interests.

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

17. 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 18-21 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 22-24 of this paper).

[2] This section comprises principally the analysis included in the staff paper discussed by the Board at its meeting in February 2016. The staff analysis included in the February 2016 board paper about the types of interests that are included in the net investment in an associate or a joint venture is included in Appendix C to this paper.

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

18. 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.* […]

19. 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 in IAS 28 apply.

20. However, paragraph 14 of IAS 28 clarifies that the scope exception in IFRS 9 applies only to interests in an associate or 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. […]

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

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

22. 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.

23. 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 merely 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.

24. 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

25. 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.

26. 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 in IFRS 9. This indicates that the Board did not intend the measurement requirements in IFRS 9 to be applied in isolation of the impairment requirements.

Summary

27. 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 in IFRS 9, including those relating to impairment, to such long-term interests to which the equity method is not applied.

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 account for the long-term interests applying IFRS 9, including applying the impairment requirements in 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 and 41A-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 the entity would ignore those losses or impairment in recognising interest revenue on the long-term interests when 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 in 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.

Assessment against the Interpretations Committee's agenda criteria

32. We have assessed this issue against the agenda criteria of the current *Due Process Handbook* as follows:

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	**Yes.** Many respondents to the outreach confirmed that they have observed this issue and that there are differing views on the accounting treatment.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No.** Although there are differing views with respect to this issue, we think that the requirements in IFRS Standards are sufficient to determine how to account for long-term interests in an associate or a joint venture.
that can be resolved efficiently within the confines of existing IFRS Standards and the *Conceptual Framework for Financial Reporting*.	Not applicable.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable.
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	Not applicable.

Staff conclusion and recommendation

33. Applying the requirements in IFRS Standards, a summary of our analysis is as follows:

    (a) the scope exception in paragraph 2.1(a) of IFRS 9 does not apply to long-term interests, because:

        (i) the scope exception in that paragraph applies only to interests in an associate or a joint venture that an entity accounts for using the equity method; and

        (ii) long-term interests are not accounted for using the equity method.

    (b) an entity accounts for long-term interests as follows:

        (i) the entity accounts for long-term interests applying the requirements in IFRS 9, including the impairment requirements in IFRS 9;

        (ii) in allocating any losses of the associate or joint venture, the entity includes 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 assesses the net investment for impairment applying the requirements in paragraphs 40 and 41A-43 of IAS 28.

34. We think that the requirements in IFRS Standards provide an adequate basis to enable an entity to determine how to account for long-term interests in an associate or a joint venture. Consequently, we recommend that the Interpretations Committee should not add the issue to its agenda. The proposed wording for the tentative agenda decision is set out in Appendix A to this paper.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff analysis and recommendation as summarised in paragraphs 33-34 of this paper?
2. Does the Interpretations Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

Appendix A—Proposed wording for tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

IFRS 9 *Financial Instruments* and IAS 28 *Investments in Associates and Joint Ventures*—Measurement of long-term interests

The Interpretations Committee received a request relating 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 applies 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, but to which the equity method is not applied ('long-term interests').

The Interpretations Committee observed that:

(a) paragraph 14 of IAS 28 clarifies that 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; and

(b) long-term interests are not accounted for using the equity method. This is because:

  (i) paragraph 38 of IAS 28 distinguishes between the investment in an associate or a 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; and

  (ii) long-term interests are subject to only one part of the equity method procedures (ie the allocation of losses).

Consequently, the Interpretations Committee concluded that the scope exception in paragraph 2.1(a) of IFRS 9 does not apply to long-term interests.

The Interpretations Committee, therefore, observed the following:

(a) the entity accounts for long-term interests applying IFRS 9, including applying the impairment requirements in IFRS 9;

(b) in allocating any losses of the associate or joint venture applying the requirements in paragraph 38 of IAS 28, the entity includes 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 then assesses for impairment the net investment in the associate or joint venture (of which the long-term interests are a part) applying the requirements in paragraphs 40 and 41A-43 of IAS 28.

In the light of the existing requirements in IFRS Standards, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B—Summary of the Board's discussion

B1. The following is a summary of the Board's discussion at its two meetings in December 2015 and February 2016:

(a) As described in paragraph 5 of the paper, most of the Board members (12 of the 14 members present) agreed with the staff analysis that the scope exception in IFRS 9 does not apply to long-term interests.

(b) Some Board members observed that paragraph 38 of IAS 28 clearly distinguishes interests that an entity accounts for using the equity method and other long-term interests that form part of the net investment.

(c) A few Board members expressed concern that long-term interests in an associate or a joint venture are subject to the impairment requirements in both IFRS 9 and IAS 28. One of those Board members thinks that an amendment should be made to IAS 28 to remove long-term interests from the scope of the impairment requirements in IAS 28.

(d) One Board member was of the view that the equity method in IAS 28 is designed to work with the inclusion of long-term interests within the 'net investment' to which an entity allocates its share of losses. Consequently, that Board member thinks that 'interests in associates and joint ventures that are accounted for using the equity method' referred to in paragraph 14 of IAS 28 should be interpreted to include such long-term interests and, therefore, those long-term interests are not within the scope of IFRS 9.

(e) Some Board members thought that the wider question of the type of interests in an associate or a joint venture subject to the equity method of accounting should be considered as part of a research project on the equity method of accounting. This wider question is discussed in Appendix C to this paper.

Appendix C—Additional question raised during the Board's discussions

C1. The following is an excerpt from the staff paper presented to the Board at its meeting in February 2016. It sets out the staff analysis in response to a suggestion made during the December 2015 Board meeting. The suggestion relates to the type of interests included in the net investment in an associate or a joint venture.

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

C2. 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'.

C3. 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.

C4. 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.

C5. 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, […]

C6. 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.

C7. 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.

C8. 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 at its meeting in November 2015.

C9. 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.