EFRAG's Draft Letter to the European Commission Regarding Endorsement of Long-term Interests in Associates and Joint Ventures (Amendments to IAS 28)

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European Commission
1049 Brussels

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Dear Mr Guersent,

Endorsement of *Long-term Interests in Associates and Joint Ventures (Amendments to IAS 28)*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on the *Long-term Interests in Associates and Joint Ventures (Amendments to IAS 28)* ('the Amendments'), which were issued by the IASB on 12 October 2017. The Amendments were included in the Exposure Draft *ED/2017/1 Annual Improvements to IFRS Standards 2015-2017 Cycle*, which was issued on 12 January 2017. EFRAG provided its comment letter on that Exposure Draft on 19 April 2017.

The objective of the Amendments is to clarify that an entity applies IFRS 9 *Financial Instruments* to other financial instruments in an associate or joint venture to which the equity method is not applied. These include long-term interests that, in substance, form part of the entity's net investment in an associate or joint venture ('long-term interests').

The Amendments become effective for annual periods beginning on or after 1 January 2019, with earlier application permitted. However, entities shall disclose that fact. A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and are not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and lead to prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS Standards and that all necessary disclosures are required. Therefore EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, lead to prudent accounting, and that they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 The IASB received a submission asking whether long-term interests in an associate or joint venture that, in substance, form part of the net investment in the associate or joint venture are within the scope of IFRS 9 *Financial Instruments*, and, if so, whether the impairment requirements in IFRS 9 apply to such long-term interests.

The issue and how it has been addressed

2 The Amendments clarify that IFRS 9 applies to financial instruments in associates or joint ventures to which the equity method is not applied. These include long-term interests that, in substance, form part of the entity's net investment in an associate or joint venture ('long-term interests'). The Amendments also clarify that:

(a) an entity applies the requirements in IFRS 9 to long-term interests before applying the loss allocation and impairment requirements in IAS 28 *Investments in Associates and Joint Ventures*; and

(b) in applying IFRS 9, the entity does not take account of any adjustments to the carrying amount of long-term interests that previously arose from the loss allocation or impairment requirements of IAS 28.

3 The impact of the Amendments is that impairment of long-term interests is addressed from two perspectives:

(a) from the perspective of the individual financial instrument that is the long-term interest; and

(b) from the perspective of the net investment as a whole, which includes the long-term interest.

When do the Amendments become effective?

4 The Amendments shall be applied retrospectively for annual periods beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies the Amendments earlier, it shall disclose that fact.

Transition

5 An entity that first applies the Amendments when it first applies IFRS 9, shall apply the transition requirements in IFRS 9 to the long-term interests.

6 An entity that first applies the Amendments after it first applies IFRS 9 shall apply the transition requirements in IFRS 9 and is not required to restate prior periods to reflect the application of the Amendments. When first applying the Amendments, an entity that applies the temporary exemption from IFRS 9 in accordance with IFRS 4 *Insurance Contracts* is not required to restate prior periods to reflect the application of the Amendments. In both cases, an entity may restate prior periods only if it is possible without the use of hindsight.

7 If an entity does not restate prior periods, at the date of initial application of the Amendments 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.

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Notes to Constituents:

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments. In it, EFRAG assesses how the Amendments satisfy the technical criteria set out in the Regulation (EC) No 1606 2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendments leads to prudent accounting and finally considers whether the Amendments would not be contrary to the true and fair view principle.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS Standards in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS Standard or Interpretation against the technical criteria for European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRS Standards or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

8 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

9 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

10 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of this Directive'* (Recital 9 of the IAS Regulation).

11 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

12 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

Relevance

13 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

14 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

IFRS 9 classification and measurement

15 As a result of applying the Amendments, entities will have to classify and measure long-term interests in accordance with IFRS 9. EFRAG has previously assessed that the requirements of IFRS 9 lead to relevant information.

16 EFRAG considers that measuring items according to their characteristics provides relevant information and is consistent with IFRS Standards. Therefore, measuring these financial instruments in accordance with IFRS 9 provides relevant information.

17 Further, the requirements in IAS 28 on the equity method do not address the accounting for long-term interests (apart from the guidance on loss allocation and impairment). It is unclear how these long-term interests would be measured under IAS 28.

18 Based on the above, EFRAG considers that IFRS 9 classification and measurement principles will bring relevant information.

IFRS 9 impairment

19 EFRAG assesses that applying IFRS 9 impairment requirements to any long-term interest carried at amortised cost provides an appropriate basis for users to understand the extent of expected credit losses resulting from credit risk of such long-term interests. As a result, it brings relevant information for assessing the likelihood of collecting future contractual cash flows.

Conclusion on relevance

20 EFRAG's overall assessment is that the Amendments result in the provision of relevant information and therefore satisfy the relevance criterion.

Reliability

21 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

22 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

23 EFRAG has previously assessed that the requirements of IFRS 9 lead to relevant information and can see no reason why this should not apply for long-term interests.

24 EFRAG's overall assessment is that the Amendments would result in the provision of reliable information and therefore satisfy the reliability criterion.

Comparability

25 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

26 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

27 EFRAG understands that there is diversity in practice in the application of the requirements of IFRS 9/IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 28 to long-term interests. This is not a new issue but its impact is likely to be more significant following the transition to the expected credit loss model under IFRS 9. EFRAG considers that the Amendments clarify the appropriate treatment and, thus, contribute to comparability of the resulting information.

28 EFRAG considers that information will be more comparable if financial instruments with similar terms and conditions are recognised and measured on the same basis. That is, the application of IFRS 9 to long-term interests will provide comparable information when the long-term interests are compared to other financial instruments, especially given that long-term interests are disclosed separately from the equity-accounted investment to which they relate.

29 EFRAG assesses that the transition reliefs provided are not expected to result in a significant loss of information and are substantiated on cost/benefit grounds. The transition reliefs provided are consistent with the transition requirements in IFRS 9, which have been assessed as providing comparable information in EFRAG's endorsement advice on IFRS 9.

30 The Amendments address existing divergence in respect of accounting for long-term interests. This will bring consistency in accounting for such interests, and therefore will increase comparability between entities. Therefore, EFRAG's overall assessment is that the Amendments satisfy the comparability criterion.

Understandability

31 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

32 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

33 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

34 EFRAG observes that the Amendments do not introduce any new concepts; they resolve diversity arising from a lack of clarity on which IFRS Standard applies in specific circumstances. That is, they clarify that the requirements of IFRS 9 are applicable to long-term interests.

35 EFRAG acknowledges that applying two different accounting requirements to the same long-term interests has the potential to impair understandability in that the recognition of impairment losses differs depending on the perspective: each

individual instrument, or the net investment as a whole. Users may find it difficult to understand the resulting effect on the financial statements. However, EFRAG considers that the disclosures in IFRS 12 *Disclosure of Interests in Other Entities*, will go some way towards providing information that will enable users of financial statements to understand and evaluate the effect of long-term interests on the entity's financial position, financial performance and cash flows.

36 EFRAG's overall assessment is that the requirements in the Amendments will result in information that is understandable.

Prudence

37 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

38 EFRAG assesses that applying IFRS 9 impairment requirements in long-term interests is a prudent approach. The impairment model of IFRS 9 uses comprehensive credit risk and forward-looking information and has been assessed to lead to prudent accounting. Recognition of 12-month expected losses from an instrument's inception brings an element of prudence. Furthermore, it recognises lifetime expected credit losses during the life of a financial asset as soon as significant credit deterioration occurs. Further, the additional overlay of the impairment requirements in IAS 28 for long-term interests will ensure that assets are not over-valued.

39 Based on the above, EFRAG has concluded that the application of the Amendments will lead to prudent accounting.

True and Fair View Principle

40 An IFRS Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

41 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards. In particular, the Amendments clarify that IFRS 9, including its impairment requirements, applies to long-term interests. Some constituents raised concerns about applying both the impairment requirements in IFRS 9 to long-term interests and the impairment requirements in IAS 28/IAS 36 *Impairment of Assets* to the net investment (which includes long-term interests). However, EFRAG observed that those respective impairment requirements are applied to different units of account.

42 Accordingly, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

43 The Amendments do not include any new disclosure requirements. EFRAG has concluded that the disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss are already required in existing IFRS Standards, including IFRS 9 and IFRS 12.

44 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

45 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to endorse the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how it/they fit into IFRS Standards as a whole;

(b) The costs and benefits associated with the Amendments; and

(c) Whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

3 EFRAG understands that there is diversity in practice in the application of the requirements of IAS 39/IFRS 9 and IAS 28 to long-term interests. EFRAG notes that the Amendments are designed to reduce divergence in practice in accounting for long-term interests by clarifying that IFRS 9, including its impairment requirements, applies to long-term interests.

4 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's initial analysis of the costs and benefits of the Amendments

5 EFRAG first considered the extent of the work. For some IFRS Standards or Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the IFRS Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

Cost for preparers

6 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

7 EFRAG observes that the Amendments do not introduce any new accounting concepts; they resolve a question from constituents regarding the scope of existing IFRS Standards. Preparers that have accounted for impairment of long-term interests by applying only IAS 28/IAS 36 requirements, will incur some costs in applying IFRS 9 to long-term interests.

8 Changes to systems are unlikely to be necessary in order to apply the Amendments, as entities will have undertaken implementation efforts in relation to IFRS 9, which is effective from 1 January 2018.

9 In response to EFRAG's draft comment letter, some constituents observed that it would be challenging to apply IFRS 9 impairment requirements to financial

instruments whose settlement is neither planned nor likely to occur in the foreseeable future. However, EFRAG notes that this challenge already exists in IFRS 9 for instruments similar to long-term interests, such as perpetual instruments envisaged in paragraph B4.1.13 of IFRS 9. Therefore, EFRAG does not consider that applying IFRS 9 impairment requirements to long-term interests will introduce undue costs for preparers.

10 The fact that, upon transition to the Amendments, there is no requirement to restate prior periods to reflect their application, will help contain the costs for preparers in implementing the Amendments.

11 As the Amendments are not introducing new requirements in IFRS Standards, EFRAG does not expect preparers to incur additional ongoing costs due to the application of the Amendments.

12 Overall, EFRAG's assessment is that the Amendments are likely to result in minor costs for preparers related to implementation of the Amendments and in insignificant costs of continuing to comply with the Amendments.

Costs for users

13 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

14 Considering that users have experience with the disclosures required by IFRS 12 and will be developing an understanding of IFRS 9, EFRAG's assessment is that implementation of the Amendments will result in some minor costs for users, which are limited to understanding the effect of the Amendments.

Benefits for preparers and users

15 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

16 EFRAG observed that the Amendments are designed to address the concerns of constituents about how an entity should account for long-term interests. EFRAG considered that the Amendments improve guidance in IAS 28 that could be interpreted in different ways. Therefore, in EFRAG's view, users will benefit from a more consistent application of the requirements in IFRS Standards as this will improve the resulting financial information on long-term interests and therefore will provide a better basis for their analysis.

17 Further, preparers are expected to benefit from reducing the effort required to determine how the guidance should be interpreted.

18 Overall, EFRAG's assessment is that users and preparers are likely to benefit from the Amendments.

Conclusion on the costs and benefits of the Amendments

19 EFRAG's overall assessment is that the overall benefits resulting from improved financial information being available on a more relevant, understandable and comparable basis are likely to outweigh the costs required to implement and continue to comply with the requirements of the Amendments.

Conclusion

20 EFRAG considers that the Amendments will bring improved financial reporting when compared to current guidance. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

21 EFRAG has not identified that the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

22 Furthermore, EFRAG has considered whether there are any other factors that would mean endorsement is not conducive to the public good and has not identified any such factors.

23 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.