



HM Treasury

IFRS 9 Financial Instruments: Public sector application guidance

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Executive summary

Since 2005, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have had a long-term objective to improve and simplify the reporting of financial instruments. In response to the financial crisis in 2007-08, the Boards decided to accelerate their plans and to revise their respective accounting standards for financial instruments to address perceived weaknesses.

The IASB developed and issued the International Financial Reporting Standard (IFRS) 9 Financial Instruments in 3 phases as a compendium of improvements, which included:

- a single approach to classification and measurement;
- a new forward-looking 'expected loss' impairment model; and
- a revised approach to hedge accounting.

The new impairment model is intended to address criticism of the impairment model used during the financial crisis, specifically, that it allowed reporting entities to delay recognition of asset impairments. The new model requires recognition of full lifetime losses more quickly.

The IASB issued the final version of IFRS 9 Financial Instruments in July 2014. This new standard replaces IAS 39 Financial Instruments: Recognition and Measurement and has an effective date of 1st January 2018.

The EU adopted IFRS 9 in November 2016. The FReM applies EU adopted IFRS consistent with the requirements of the Government Resource Accounts Act 2000. This means the new standard is to be applied in central government from 2018-19.

The FReM interprets¹ IFRS 9 for the public sector context in the following ways, as set out in FReM Chapter 6:

- Any financial instrument that is not held in furtherance of the entity's objectives but is held on behalf of government more generally should be accounted for in a separate Trust Statement. Entities should discuss such cases with the relevant authorities;
- Special or 'golden' shares, being those shares retained in businesses that have been privatised but in which the department wishes to retain a

¹ The FReM has retained the existing IAS 39 interpretations and these will continue to apply once IFRS 9 is adopted in the public sector.

regulatory interest or reserve power, should not be recognised in the Statement of Financial Position;

- PDC should be reported at historical cost, less any impairment;
- Where future cash flows are discounted to measure fair value, entities should use the higher of the rate intrinsic to the financial instrument and the real financial instrument discount rate set by HM Treasury (promulgated in PES papers) as applied to the flows expressed in current prices;
- The accounting policy choice allowed under IFRS 9 for long term trade receivables, contract assets which do contain a significant financing component (in accordance with IFRS 15), and lease receivables within the scope of IAS 17 has been withdrawn and entities should always recognise a loss allowance at an amount equal to lifetime expected credit losses (ECLs). All entities applying this Manual should utilise IFRS 9's simplified approach to impairment for relevant assets;
- The accounting policy choice allowed under IFRS 9 which allows entities to either continue to apply the hedge accounting requirements of IAS 39 (until the macro hedging project is finalised) or to apply IFRS 9 has been withdrawn. All entities applying this Manual should apply IFRS 9 hedge accounting requirements (with the scope exception only for fair value macro hedges of interest rate risk); and
- The accounting policy choice allowed under IFRS 9 which allows entities upon transition to restate prior periods if, and only if, it is possible without the use of hindsight has been withdrawn. All entities applying this Manual shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application.

The FReM adapts IFRS 9 for the public sector context in the following ways, as set out in FReM Chapter 6:

- Balances with core central government departments (including their executive agencies), the Government's Exchequer Funds², and the Bank of England are excluded from recognising stage-1 and stage-2 impairments. In addition, any Government Exchequer Funds' assets where repayment is ensured by primary legislation are also excluded from recognising stage-1 and stage-2 impairments. ALBs are excluded from the exemption unless they are explicitly covered by guarantee given by their parent department; and
- Liabilities with core central government departments (including their executive agencies), the Government's Exchequer Funds, and the Bank of

² Government's Exchequer Funds include: the National Loans Fund; all Consolidated Funds; the Contingencies Fund; the Exchange Equalisation Account; the Debt Management Account; the Public Works Loan Board; and Commissioners for the Reduction of the National Debt.

England are assessed as having zero 'own credit risk' by the entities holding these liabilities.

This guidance focuses on the public sector application of IFRS 9, and not the application of the Standard itself, and sets out the basis for the public sector adaptations and interpretations. It does not seek to duplicate the extensive guidance and illustrative examples already included within IFRS 9, nor take away the judgements each entity will be required to make when applying IFRS 9.

For further information and guidance, please refer to:

- Government Financial Reporting Manual - <https://www.gov.uk/government/collections/government-financial-reporting-manual-frem>
- Financial Reporting Advisory Board - <https://www.gov.uk/government/groups/financial-reporting-advisory-board-frab>
- One Finance, Government Financial Reporting - <https://www.epims.ogc.gov.uk/OneFinance/home/89/Government-Financial-Reporting>
- Consolidated Budgeting Guidance - <https://www.gov.uk/government/collections/consolidated-budgeting-guidance>
- Estimates Manual – <https://www.gov.uk/government/publications/supply-estimates-guidance-manual>
- Classification guidance - <https://www.gov.uk/government/publications/introduction-to-classification>

Chapter 1

Overview of IFRS 9

- 1.1 IFRS 9 has an effective date of 1st January 2018 following adoption by the EU in November 2016. A narrow-scope amendment¹ to the Standard was issued by the IASB in October 2017 and EU adoption of the amendment is only expected in 2018. HM Treasury will more fully review the amendment nearer to the endorsement date and will flag any material issues when the final version of the 2018-19 FReM is submitted to the Financial Reporting Advisory Board (FRAB) for approval before publication.
- 1.2 IFRS 9 is to be applied in central government from 2018-19. Early adoption is not permissible for central government entities, to ensure consistency for group consolidations and the Whole of Government Accounts (WGA), unless with the express approval of HM Treasury. It is to be applied retrospectively subject to transitional reliefs, for example, the 2018-19 FReM mandates an option provided in IFRS 9 not to restate prior periods. All elements of IFRS 9 must be applied wholly except for own credit changes (which can be applied without otherwise changing the accounting for financial instruments).
- 1.3 IFRS 9 produces a more principles-based approach to the accounting for financial instruments, including their classification and measurement. For those financial instruments not measured at fair value through profit or loss, an objective of IFRS 9 is to provide users with more useful information about an entity's expected credit losses (ECLs); it provides an update of the amount of ECLs recognised at each reporting date due to changes in the credit risk of financial instruments. For hedge accounting, it introduces a model that is better aligned with most internal risk management processes.
- 1.4 IFRS 7 Financial Instruments: Disclosures requires organisations to disclose changes in categories of financial instruments because of IFRS 9 and the financial impact of those changes. IFRS 7 disclosure requirements regarding valuation techniques have been relocated to IFRS 13 Fair Value, adopted in the public sector in 2015-16. There are other consequential amendments to other standards as a result of IFRS 9, for example:
 - IAS 1: impairment losses, including reversals of impairment losses and impairment gains, are presented in a separate line item in the Statement of Profit or Loss and Other Comprehensive Income.

¹ Prepayment Features with Negative Compensation: <http://www.ifrs.org/news-and-events/2017/10/international-accounting-standards-board-issues-narrow-scope-amendments-to-ifrs-9-and-ias-28/>

Impact on financial statements

- 1.5 IAS 32 Financial Instruments: Presentation defines a financial instrument as “any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.” The full definitions for financial assets and liabilities are set out in IAS 32 paragraph 11.
- 1.6 Financial assets and financial liabilities are recognised when an entity becomes a party to the contractual provisions of the instrument, subject to IFRS 9 paragraphs B3.1.1 and B3.1.2. Detailed derecognition requirements for financial assets are set out in IFRS 9 section 3.2. Financial liabilities must be derecognised when the liability has been extinguished, that is when the obligation specified in the contract has been discharged, cancelled or has expired.

Classification and measurement

Financial assets

Table 1.A: Summary of the classification and measurement model for financial assets

Are the cash flows considered to be solely principal and interest?	What is the business model?	What is the measurement category?	Are alternative options available?
YES	Held to collect contractual cash flows only	AC	FVTPL option ²
YES	Held to collect contractual cash flows AND to sell	FVOCI ³	FVTPL ²
YES	All other strategies	FVTPL	
NO		FVTPL	FVOCI option for equity investments ⁴

- 1.7 IFRS 9 replaces most of the guidance in IAS 39 and has reduced the number of classifications for financial instruments. IFRS 9 applies a single classification and measurement approach to all types of financial assets. This eliminates the complex requirements for bifurcating of hybrid financial assets. The entire hybrid instrument is assessed for classification and embedded derivatives are no longer separated from financial asset hosts.
- 1.8 IFRS 9 includes a rationale for classification which is based on two criteria. The Standard moves away from IAS 39 reliance on the terms of an instrument (and whether it is traded or not) and looks to the entity's business

² If at initial recognition the financial asset is irrevocably designated at FVTPL as doing so eliminates or reduces a measurement or recognition inconsistency.

³ Interest, impairment and foreign currency recognised in PoL, with all other gains or losses recognised in other comprehensive income. Upon derecognition amounts in other comprehensive income are reclassified to PoL.

⁴ Dividends recognised in PoL with all other gains or loss recognised in other comprehensive income. Upon derecognition amounts in other comprehensive income are not reclassified to PoL.

model for managing financial assets and creation of value through the contractual cash flow characteristics of the financial asset.

- 1.9 The measurement categories for financial assets reflect the nature of their cash flows and the way they are managed and they are:
- Financial assets measured at amortised cost (AC);
 - Financial assets measured at fair value through other comprehensive income (FVOCI); and
 - Financial assets measured at fair value through profit or loss (FVTPL).
- 1.10 The above measurement categories allowed for under IFRS 9 are dependent on two criteria. Financial assets (that are debt instruments) measured at AC are held in a business model whose objective is to hold assets to collect contractual cash flows only, for example, a simple debt instrument not classified at fair value.
- 1.11 In contrast, financial assets classified and measured at FVOCI are held in a business model whose objective is achieved by collecting contractual cash and selling financial assets. This category is mandatory for some debt instruments (i.e. all except those measured at AC or FVTPL) and irrevocably elected equity instruments (which can also be measured at FVOCI although differently from debt instruments).
- 1.12 The financial asset is measured at fair value in the Statement of Financial Position (SoFP). Interest revenue, foreign exchange gains and losses and impairment gains and losses are recognised in profit or loss (PoL) with all other gains or losses (i.e. the difference between those items and the total change in fair value) being recognised in OCI. This approach may result in significantly lower volatility in PoL which would otherwise have arisen.
- 1.13 The FVOCI classification differs from the 'available for sale' classification under IAS 39 as it is no longer the 'residual category'. Interest income and impairment gains and losses would be recognised and measured in the same manner as for assets measured at AC such that the amounts in OCI represent the difference between AC and fair value. This results in the same information in PoL, as if the asset was measured at AC, yet the SoFP would reflect the asset's fair value. The treatment of fair value movement is now more aligned across the varying categories of different financial assets, allowing more useful comparability of entities with financial instruments.
- 1.14 All equity investments are measured at fair value under IFRS 9 and all changes in their fair value are recognised in PoL (the default approach) unless the entity elects, permanently and on an instrument-by-instrument basis at initial recognition, to recognise fair value changes in OCI (whilst dividends are recognised in PoL). This option only applies to equity investments which are not held for trading.
- 1.15 Any financial assets that are not held in one of the above two categories are measured at FVTPL. This represents a 'residual category' - i.e. for debt

instruments designated to this category using the fair value option⁵ and all other equity instruments, excluding those elected above, and all derivatives.

- 1.16 The fair value of the asset is provided both in the SoFP and in PoL. Gains or losses from interest, foreign exchange and other fair value movements are separately reported in PoL and transaction costs are expensed as they are incurred.

Reclassification of financial assets

- 1.17 Financial assets are reclassified between measurement categories only when the entity's business model for managing them changes. This should be a significant event, which is uncommon, and therefore ensures users of the financial statements are always provided with information reflecting how the cash flows on financial assets are expected to be realised. This reclassification process also eliminates the need for the complex tainting rules that are contained in IAS 39.
- 1.18 IFRS 7 requires relevant disclosures to ensure users can see what has occurred: including the financial effects of the financial assets moved between measurement categories and a detailed explanation of the change in business model and its effect.

Financial liabilities

- 1.19 IFRS 9 carries forward unchanged almost all the accounting requirements in IAS 39 for financial liabilities. No changes were introduced for the classification and measurement of financial liabilities, except for the recognition of changes (i.e. the effect) in own credit risk. The final version of the Standard has responded to longstanding concerns about the volatility that occurs in PoL due to changes in an issuer's own credit risk when non-derivative financial liabilities are designated under the FVO as being measured at FVTPL.
- 1.20 The Standard introduces new requirements for the accounting and presentation of these changes in the fair value of an entity's own debt when the entity has chosen to measure the debt at fair value under the fair value option. The fair value option permits entities to elect to measure a structured financial liability at fair value in its entirety rather than being required to account for its component parts.
- 1.21 Fair value changes of these financial liabilities which are attributable to the change in the entity's own credit risk are presented in OCI with no recycling, rather than in PoL, removing the counterintuitive treatment under IAS 39. Under IAS 39 (i.e. presented in PoL), when an entity's own credit quality deteriorates, the value of these liabilities will reduce. If the liabilities are measured at fair value, then a gain is recognised in the PoL and vice versa. Under IFRS 9 these liabilities will continue to be measured in the SoFP at fair value.

⁵ The fair value option is available on initial recognition as an alternative to measuring at FVOCI, particularly if it would eliminate or reduce an accounting mismatch (i.e. a measurement or recognition inconsistency). See IFRS 9 paragraphs B4.1.29 to B4.1.32 for more information.

- 1.22 The only exceptions to the above are if:
- OCI presentation would create or enlarge an accounting mismatch in PoL;
or
 - The liability is a loan commitment or financial guarantee contract.
- 1.23 All other guidance in IAS 39 related to the recognition and measurement of financial liabilities has been carried forward into IFRS 9.

Narrow-scope amendments

- 1.24 In October 2017, the IASB issued narrow-scope amendments to IFRS 9. Under the current IFRS 9 requirements, the SPPI condition is not met if the lender must make a settlement payment in the event of termination by the borrower (also referred to as early repayment gain).
- 1.25 'Prepayment Features with Negative Compensation (Amendments to IFRS 9)'⁶ amends the existing requirements in IFRS 9 regarding termination rights to allow measurement at AC (or, depending on the business model, at FVOCI) instead of at FVTPL, even in the case of negative compensation payments.
- 1.26 The sign of the prepayment amount is not relevant. So, depending on the interest rate prevailing at the time of termination, a payment may also be made in favour of the contracting party effecting the early repayment. The calculation of this compensation payment must be the same for both the case of an early repayment penalty and the case of an early repayment gain.
- 1.27 These amendments to IFRS 9 also contain a clarification (in the Basis for Conclusions) concerning the accounting for financial liabilities following a modification or exchange of a financial liability measured at AC that does not result in the derecognition of the financial liability. The amendment confirms that most such modifications will result in immediate recognition of a gain or loss. This is a change from common practice under IAS 39 and will affect entities that have renegotiated borrowings.
- 1.28 The IASB clarifies that an entity recognises any adjustment to the AC of the financial liability arising from a modification or exchange in PoL at the date of the modification or exchange. A retrospective change of the accounting treatment may therefore become necessary if in the past the effective interest rate was adjusted and not the AC amount.
- 1.29 The above amendments are to be applied retrospectively for fiscal years beginning on or after 1 January 2019 – i.e. one year after the first application of IFRS 9 in its current version. The Standard permits early application of the narrow-scope amendments – i.e. an entity can consider the effect of the amendments when it initially applies IFRS 9. In such cases, an entity would apply the transition provisions in section 7.2 of IFRS 9 (as issued in 2014) to all financial assets and financial liabilities within the scope

⁶ <http://www.ifrs.org/news-and-events/2017/10/international-accounting-standards-board-issues-narrow-scope-amendments-to-ifrs-9-and-ias-28/>

of that Standard. No specific transition provisions are needed for the amendments.

- 1.30 EU adoption of the amendment is only expected in 2018. HM Treasury will more fully review the amendment nearer to the endorsement date and will flag any material issues (if any) when the final version of the 2018-19 FReM is submitted to the FRAB for approval before publication.
- 1.31 HM Treasury strongly suggest that public sector entities ensure that their projects to implement IFRS 9 identify what assets and transactions are or may be affected by these amendments to the Standard and should be assessing the impact from the outset. Significant judgement may be required to apply the amendment, so early identification of the issues is advised. Reporting entities wanting to early adopt these amendments as a part of the introduction of IFRS 9 in 2018-19 should engage with HM Treasury to seek approval in the first instance.

Impairment

- 1.32 Delayed recognition of credit losses on loans and other financial instruments has been identified as a weakness in existing accounting standards. IFRS 9 contains a forward looking expected loss impairment model and requires the same measurement basis for impairment for all items subject to its impairment requirements such as, but not limited to: trade receivables; lease receivables within scope of IAS 17 Leases; and contract assets⁷ within scope of IFRS 15 Revenue from Contracts with Customers.
- 1.33 Furthermore, the measurement of certain loan commitments and financial guarantee contracts is based on the IFRS 9 impairment requirements rather than those of IAS 37 Provisions, Contingent Liabilities and Contingent Assets. This model will result in earlier and timelier recognition of ECLs.
- 1.34 IFRS 9 sets out a three-stage model for impairment, known as the 'general approach'. Under the general approach, entities must at each stage of the model recognise a loss allowance for ECLs against any of the financial instruments subject to impairment accounting. ECLs are defined as the weighted average of credit losses, with the respective risks of a default occurring as the weights.
- 1.35 At each reporting date, entities must consider whether the credit risk on a financial instrument has increased significantly since initial recognition (see IFRS 9 paragraphs 5.5.9 to 5.5.11). If it has not, then a loss allowance equal to 12-month ECLs is recognised. This is known as a 'stage-1' impairment.
- 1.36 If the credit risk has increased significantly since initial recognition, then a loss allowance equal to lifetime ECLs is recognised. This is known as a 'stage-2' impairment. If the credit risk subsequently improves, then it is possible for

⁷ 'Contract asset' is a term introduced by the new revenue recognition standard IFRS 15 Revenue from Contracts with Customers. IFRS 15 provides a detailed definition but contract assets are generally equivalent to unbilled revenue. Even though contract assets are not financial assets, and are accounted for mainly under IFRS 15, IFRS 9's impairment requirements apply to them. This means that when entities recognise revenue in advance of being paid or record a receivable, they also need to recognise an expected credit loss.

a financial instrument to revert to 'stage-1' with a consequent reduction in the loss allowance.

- 1.37 A 'stage-3' impairment occurs when there is evidence of the occurrence of a default event and a loss allowance equal to lifetime ECLs is recognised. A financial asset, or part of a financial asset, is written off and derecognised when the entity has no reasonable expectation of recovering it.
- 1.38 This model is a fundamentally different approach to the impairing of financial instruments compared with the IAS 39 'incurred loss' model, which delays the recognition of credit losses until there is evidence of a credit loss.
- 1.39 It is no longer necessary for a 'loss event' trigger to have occurred before credit losses are recognised. IFRS 9 still has an event trigger but this is based on a significant deterioration in the instrument and results earlier in the credit lifespan. For financial instruments that have met the trigger, IFRS 9 requires entities to calculate the impairment allowance on financial assets based on the losses they expect to have during the life of the instrument - i.e. its expected shortfall looking forward over the lifetime of the exposure.
- 1.40 The new model also requires that an impairment allowance, for ECLs, is raised even where no evidence of deterioration is present. Typically, when a financial asset, excluding purchased or originated credit-impaired financial assets, is first recognised a 12-month expected loss allowance is recognised. If a significant increase in credit risk occurs (i.e. an event trigger), the 12-month expected loss allowance moves to an allowance for lifetime expected losses thereby increasing the amount of impairment recognised.
- 1.41 IFRS 9 also includes a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due. Under the Standard, if a significant increase in credit risk has subsequently reversed in the next reporting period, the loss allowance reverts to being measured based on an amount equal to the 12-month ECLs.
- 1.42 An entity should use all its available information to determine if deterioration has occurred and the lifetime losses it expects will be incurred. Thus, more timely information is required to be provided about ECLs. Under the Standard an entity is to base the measurement of ECLs on reasonable and supportable information available without undue cost or effort; this may include a variety of historical, current and forecasting information. IFRS 9 does not prescribe measurement methods and various data sources (internal and external) may be used.
- 1.43 Both debt instruments measured at AC and those measured at FVOCI will have the same loan loss allowance despite the different measurement methods on the SoFP which will result, for example, in more comparable loan loss results amongst entities with similar assets.
- 1.44 The Standard does not define what is meant by 'significant' and so judgement will be needed to determine whether financial assets should be transferred between impairment allowance categories.
- 1.45 It should be noted that the Standard does include an exception (practical expedient) to the general impairment model, if the credit risk of a financial

instrument is low at the reporting date – i.e. it is assumed that credit risk has not increased significantly at each reporting date. This practical expedient allows the entity to only recognise 12-month ECLs for financial instruments with the following characteristics:

- there is a low risk of default – e.g. external rating of investment grade or an internal credit rating equivalent.;
- the borrower is considered, in the short term, to have a strong capacity to meet its contractual cash flow obligations; and
- the lender supposes, in the longer term, that unfavourable changes in economic and business conditions might, but will not necessarily, reduce the ability of the borrower to pay.

1.46 The main difference in scope to IAS 39 is that certain loan commitments and financial guarantee contracts are assessed for impairments under this Standard rather than IAS 37. This alignment seems reasonable as a forecast credit loss on a potential drawdown on a loan will now be measured the same way as if it is drawn down.

1.47 More extensive and improved disclosures under IFRS 7 are required to accompany the accounting due to the number of judgements and assumptions required to apply the model, particularly on ECLs and credit risk. This is a move to increase transparency on the application and to ensure users of the financial statements can make comparisons and track changes in provisions over time.

Hedge accounting

1.48 Hedging is the use of financial instruments to manage exposure to risk by offsetting changes in fair values or cash flows of another transaction. When derivatives are used as a tool for risk management, normal accounting requirements would lead to additional volatility in the PoL. Hedge accounting is a way to reduce such volatility.

1.49 Typically, a relationship is designated between the hedged item, which is exposed to the specified risk, and a hedging instrument, which varies to offset changes in the hedged item. Depending on the nature of the hedge, gains and losses arising from this relationship are taken either to PoL or to equity.

1.50 Only qualifying instruments may be designated as a hedging instruments. The requirements for this under IFRS 9 are less restrictive than previously existed under IAS 39, and hedge accounting may therefore be applied in a wider range of circumstances.

1.51 IFRS 9 introduces a revised model for hedge accounting which principally aims to align the accounting treatment with risk management activities; hedging financial and non-financial exposures.

1.52 The Standard moves away from a rules-based approach and has increased preparers' ability to account for hedges of non-financial items that currently fail to qualify. The new model also allows entities to apply hedge accounting

more broadly to manage PoL mismatches and remove what might be regarded as 'artificial' hedge ineffectiveness.

- 1.53 The IASB has not yet completed its project on macro hedge accounting. The Board separated this issue from general hedge accounting, creating a separate project, and designed IFRS 9 so that entities are not adversely affected whilst the project is ongoing. Entities applying fair value macro hedging will continue to use the IAS 39 fair value macro hedging model after adoption of IFRS 9. In addition, at initial application an entity may elect to continue to apply the general hedge accounting requirements of IAS 39 instead of those of IFRS 9 as an accounting policy choice. Even though this election has been provided to avoid disruption to macro cash flow hedging arrangements, it may be taken by any entity and will apply to all hedge relationships covered by the general model (i.e. all hedge relationships apart from macro fair value hedges).
- 1.54 Under both IFRS 9 and IAS 39, hedge accounting will remain optional (on a hedge by hedge basis) but there is no option to de-designate hedge accounting under the new Standard, i.e. voluntary discontinuation (permitted by IAS 39) is not permitted by IFRS 9. There are extensive disclosure requirements irrespective of which model (IFRS 9 or IAS 39) is applied. To note, IFRS 9 has more disclosure requirements under IFRS 7 on hedge accounting than IAS 39.
- 1.55 The IAS 39 cash flow, fair value and net investment models are retained and largely unchanged under IFRS 9. Furthermore, measuring hedge effectiveness is still required, hedge documentation is still required and hedge ineffectiveness is still to be reported in PoL. The main differences in IFRS 9 compared to IAS 39 are a broadening of the scope of qualifying hedging instruments and qualifying hedged items and the treatment of the 'cost of hedging'. For example, when using a foreign currency forward contract, the currency basis is an unavoidable 'cost' of the hedging instrument. The IASB has determined that currency basis spreads are a 'cost of hedging' and should be recognised in PoL at the same time as the hedged transaction.

Chapter 2

Transition arrangements

- 2.1 There are several considerations to evaluate as a part of the transition from IAS 39 to IFRS 9. These include the transition arrangements around retrospective application (and the associated reliefs) and other transition considerations. These transition arrangements must be assessed whilst implementing the Standard's three phased approach of: classification and measurement; impairment methodology; and hedge accounting.
- 2.2 The date of initial application is the date when an entity first applies the transition requirements of IFRS 9 and must be the beginning of a reporting period after the Standard is issued. Entities must have made certain key assessments by this date including:
- assessing which financial assets meet the contractual cash flow condition of solely payments of principal and interest (SPPI);
 - designating or revoking designations for financial instruments as at FVTPL;
 - designating investments in equity instruments that are not held for trading as at FVOCI;
 - consideration of the objective of the business model (or models) within which financial assets are held;
 - assessing whether presenting the effects of changes in a financial liability's credit risk in OCI would create or enlarge an accounting mismatch in PoL - i.e. an entity will need to determine whether offsetting assets treated at FVOCI would increase the volatility within PoL due to the liabilities impacting PoL;
 - determining whether there has been a significant increase in credit risk since initial recognition, or whether that determination would require undue cost or effort, as part of the assessment of impairment; and
 - evaluating conformity with qualifying hedge accounting criteria.
- 2.3 IFRS 9 and the associated transitional requirements are not applied to items that have been derecognised at the date of initial application.

Retrospective application considerations

- 2.4 IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors states that retrospective application results in the most useful information to users because the information presented for all periods is comparable. IFRS 9 is to

be applied retrospectively, subject to some transitional relief in some circumstances.

- 2.5 When an entity transitions to and adopts the classification and measurement approach of IFRS 9 it is required to provide the disclosures as per IFRS 7 but does not need to restate prior periods. This approach requires that an entity recognise any difference between the previous carrying amounts and the carrying amounts under IFRS 9 at initial application as part of the opening balance of reserves.
- 2.6 If an entity elects not to restate comparative periods, quantification of adjustments is still necessary to determine the transition adjustments in the opening balances in reserves/other components of equity, as appropriate - i.e. not for fair value items measured at FVTPL or FVOCI. The difference between the previous carrying amounts and the new carrying amounts is recorded in the opening balances of the annual period including the initial application date.
- 2.7 IFRS 9 requires modified transition disclosures instead of the restatement of comparative financial statements if this is the approach taken. IFRS 7 includes modified transition disclosure requirements that focus on changes in the SoFP at the date of initial application of IFRS 9 and focus on the effect on the key financial statement line items for the current period.
- 2.8 To improve consistency across the public sector and to better facilitate the consolidation of public sector entities within the WGA, the Standard has been interpreted for the public sector context such that the accounting policy relating to the transition to IFRS 9:
- The accounting policy choice allowed under IFRS 9 which allows entities upon transition to restate prior periods if, and only if, it is possible without the use of hindsight has been withdrawn. All entities applying this Manual shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application.
- 2.9 Therefore, all entities applying the FReM shall recognise the difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening general fund within taxpayers' equity (or other component of equity, as appropriate).

Transitional reliefs for retrospective application

- 2.10 IAS 8 also sets out transition requirements that apply if retrospective application is impracticable and prohibits the use of hindsight when applying a new accounting policy to a prior period.
- 2.11 Where it is impracticable to make the necessary assessments related to the modified time value of money element or the fair value of a prepayment feature of a financial asset based on the facts and circumstances as they

existed at the date of initial recognition of the financial asset, then the relief given by the related guidance is not considered in the assessment of the SPPI condition.

- 2.12 It may be unrealistic for an entity to apply the effective interest method or impairment methodology retrospectively in some situations, particularly for an entity with many financial assets that were previously measured at fair value but are measured at AC in accordance with the approach in IFRS 9. Furthermore, several loss events and reversals might have occurred between the date when the asset was initially recognised and the date of initial application of the Standard.
- 2.13 For unquoted equity instruments (or a derivative liability on such an investment) previously accounted for at cost under IAS 39, the Standard requires for it to be measured at fair value at the date of initial application. This approach may have consequential impacts on the opening balance of reserves, at initial application, if there is any difference between the previous carrying amount and the fair value.

Classification and measurement

Financial assets

- 2.14 IFRS 9 requires an entity to assess the contractual cash flows of its financial instruments and to determine whether the objective of its business model, based on circumstances at the date of initial application, is to manage financial assets to collect the contractual cash flows, to sell financial assets or both.
- 2.15 Financial instruments are classified and measured at either AC or fair value (i.e. FVOCI or FVTPL), with the resulting designation and classification applied retrospectively irrespective of the entity's business model in prior periods. The IASB believes it would be impracticable to assess the business model condition based on circumstances when the instrument first satisfied the recognition criterion in IAS 39.
- 2.16 IFRS 9 changes the classification of some financial assets, including eliminating two of the three eligibility criteria in IAS 39 for the fair value option for financial assets. IAS 39 contained two additional fair value options for financial assets: the 'managed on a fair value basis' and the hybrid contract condition. These fair value options have been eliminated under IFRS 9 given that the Standard would normally require these types of instruments to be accounted for as FVTPL. Consequently, an entity should reconsider at transition its original assessment of whether to designate a financial asset or financial liability at FVTPL.
- 2.17 Any equity investment for which an assertion was made under IAS 39 that the fair value could not be reliably determined, and which were measured at cost, are now all required under IFRS 9 to be measured at fair value. The guidance¹ issued as part of the IASB's Education Initiative for measuring the fair value of unquoted equity instruments is likely to be useful in this regard.

¹ <http://www.ifrs.org/-/media/feature/implementation/ifrs-13/education-ifrs-13-eng.pdf>

Financial liabilities

- 2.18 IFRS 9 has not changed IAS 39's classification and measurement approach for financial liabilities, including the eligibility conditions for the irrevocable fair value option for financial liabilities. The Standard does not permit entities to reassess their elections of liabilities (except in the case described below) because the underlying classification and measurement approach has not changed.
- 2.19 An entity is required to assess whether presenting the effects of changes in a liability's credit risk in OCI would create or enlarge an accounting mismatch in PoL- based on facts and circumstances that exist at the date of initial application. This is consistent with the other transition requirements in IFRS 9 related to the fair value option.
- 2.20 The application of the fair value option for financial instruments is reassessed based on the facts and circumstances at the date of initial application. If the accounting mismatch criterion is met, then an election to designate any financial asset/liability as at FVTPL may be made. It should be noted that any previous designation of a financial liability at FVTPL may only be revoked if the liability was originally designated based on the accounting mismatch criterion.
- 2.21 Where there is a hybrid contract (i.e. an embedded derivative and a host) and the entity measures the contract at fair value under IFRS 9 then, if in previous periods the contract had not been measured at fair value, the Standard requires the sum of the fair value of the embedded derivative and the host to be used as an estimate of fair value of the entire contract. This detail should be available as under the IFRS 7 disclosure requirement both fair values would have been measured separately. This approach may have consequences for the opening balance of reserves at initial application.
- 2.22 Hybrid financial liabilities previously designated as FVTPL must continue to be accounted for as such under IFRS 9. Designation or revocation under the fair value option may be made at any time during preparation of the financial statements for the first reporting period of the Standard. Revised classification because of the designation of FVTPL or revocation is applied retrospectively.

Impairment methodology

- 2.23 Under IFRS 9 this changes from an incurred loss basis to a three stage, forward looking provisioning, based on expected losses (i.e. expected cash flow assessment). This is a significant departure from IAS 39, focussing on a forward assessment of asset quality and changes to the composition of impaired assets over time. These are aimed at increasing transparency and understanding and the requirements are to be applied retrospectively.
- 2.24 There is a requirement under IFRS 9 to identify conditions indicative of significant credit risk deterioration and to reflect changes in expected losses due to forward looking economic, policy and regulatory changes. Determining credit risk at the date a financial instrument was initially recognised is to be completed without undue cost or effort and is to be compared with the credit risk at date of initial application of IFRS 9.

- 2.25 If this is not possible, an entity is to recognise a loss allowance equal to lifetime ECLs at each reporting date until the financial instrument is derecognised, except if it is a low credit risk at reporting date. Entities may also rely on the rebuttable presumption (that the condition for recognising lifetime ECLs is met when payments are more than 30 days past due) on transition.

Hedge accounting

- 2.26 In accordance with the Standard, at initial application an entity may choose to continue to apply IAS 39's hedge accounting requirements instead of the requirements under IFRS 9. This would apply to all hedging relationships.
- 2.27 Hedging as a strategy is not actively encouraged in central government, in line with the principles of Managing Public Money (MPM), as government can absorb and manage these types of risks. Therefore, to improve consistency across the public sector and to better facilitate the consolidation of public sector entities within the WGA, the Standard has been interpreted for the public sector context, the following accounting policy relating to hedge accounting is mandated:
- The accounting policy choice allowed under IFRS 9 which allows entities to either continue to apply the hedge accounting requirements of IAS 39 (until the macro hedging project is finalised) or to apply IFRS 9 has been withdrawn. All entities applying this Manual should apply IFRS 9 hedge accounting requirements (with the scope exception only for fair value macro hedges of interest rate risk).
- 2.28 Restatement of comparative period financial statements would only occur in limited circumstances related to hedge accounting. The Standard does not require specific transition provisions for financial assets. Derivative liabilities that were previously accounted for at cost (i.e. derivatives that are linked to equities for which a reliable fair value cannot be determined under IAS 39) are measured at fair value at the date of initial application of IFRS 9. Consistently with the requirements for financial assets, an entity will not have the necessary information to determine fair value retrospectively without using hindsight.

Other transition considerations

- 2.29 Even entities that have relatively simple financial assets are likely to see significant changes, both potentially from the new classification and measurement approach and due to the new impairment model, because of the implementation of IFRS 9. Therefore, changes to systems and processes, sometimes significant, are likely to be needed.
- 2.30 IFRS 9 introduces the need for additional data to support both methodology and disclosure requirements. For example, stage-1 of the expected loss model is most likely to be the most burdensome of the three stages as it may require disclosures of internal processes for its calculation and there is risk of subjectivity. Data structures may need to be adapted to include modified assets and other data to support lifetime expected loss and likelihood of non-payment.

- 2.31 New infrastructure (such as developing new processes, systems and controls) may be needed to ensure entities can run the existing IAS 39 and IFRS 9 models concurrently. This is likely to only be necessary for entities with a significant number of financial instruments (or complex instruments). There are likely to be further costs arising from educating preparers on the requirements of the Standard.
- 2.32 Entities may also face substantial challenges principally driven by the need to understand drivers of impaired assets and risk measures at a lower level of granularity compared to IAS 39. The increased volume and granularity of disclosure requirements may also become a cost driver.
- 2.33 Other implementation issues which may increase the cost of applying the classification and measurement requirements of IFRS 9 in periods prior to their date of initial application are: the interaction between the date of initial application and the fact that IFRS 9 is not applied to items that have already been derecognised as of the date of initial application; the initial business model determination and analysis of contractual cash flows on transition; and the elections for the fair value option and the FVOCI presentation alternative at the date of initial application.
- 2.34 The transition provisions of IFRS 9 are complex. In planning for the adoption of IFRS 9 it is important that preparers have a good understanding of how IFRS 9 will impact on the transition and business as usual thereafter.
- 2.35 IFRS 9 requires all entities to supply additional disclosures on transition. These are aimed at increasing transparency and understanding drivers for impaired assets. Disclosures about changes in an accounting policy are required by IAS 8. The IAS 8 disclosures may increase the burden on preparers of the financial statements as they will not only have to disclose the descriptions of the transitional provisions (including those that may have an impact on future periods) but they will also have to disclose the following:
- the amount of the adjustment made to the financial statements (for the current and each prior period reported on to the extent that this is realistic);
 - the adjustment relating to periods before those present (again, only if practical); and
 - an explanation and description of how the change was applied if retrospective application is impracticable.

Chapter 3

Application of the business model in the public sector

Approach to classification and measurement

- 3.1 Under IFRS 9 an entity should classify its financial assets into two primary measurement categories, based on:
- the contractual cash flow characteristics of a financial asset; and
 - the entity's business model for managing the financial assets.¹
- 3.2 A financial asset can only be measured at AC if two conditions are met:
- the financial asset has the features of a basic lending arrangement; and
 - the financial asset is managed on a contractual cash flow basis.
- 3.3 A financial asset that does not meet both conditions above should be measured at fair value.
- 3.4 The IASB intended for IFRS 9 to help users understand the financial reporting of financial assets by aligning the measurement attribute of financial assets with the way that the entity manages its financial assets ('business model') and their contractual cash flow characteristics. The intention being to provide relevant and useful information to users for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.
- 3.5 The business model of the entity is not considered in isolation to the contractual cash flow characteristics when determining how to measure financial assets. Following responses to the 2009 Exposure Draft (Classification and Measurement)², the IASB concluded that it would be more efficient for an entity to consider the business model condition first but to assess the contractual cash flow characteristics as well, if the model is collecting contractual cash flows, to ensure that AC provides relevant information to users.

The business model assessment

- 3.6 An entity's business model³ refers to how an entity manages its financial assets to generate cash flows. The business model determines whether cash

¹ IFRS 9, paragraph 4.1.1

² <http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognition/Exposure-Draft-and-Comment-Letters/Pages/Exposure-Draft-and-Comment-Letters.aspx>

³ IFRS 9, Appendix B application guidance, paragraph B4.1.2A

flows will result from collecting contractual cash flows, selling financial assets or both.

- 3.7 An entity will make the assessment of its business model based on circumstances that it reasonably expects to occur and should exclude 'worst case' or 'stress case' situations. For example, if an entity expects it will sell a portfolio of financial assets only in a 'stress case' scenario, then this would not affect the entity's assessment of the business model for those assets if the entity does not reasonably expect it to occur.
- 3.8 All relevant evidence that is available at the date of the assessment needs to be considered. Such relevant evidence includes, but is not limited to:
- how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel (per IAS 24 Related Party Disclosures);
 - the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and
 - how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).⁴
- 3.9 To assess whether the business model is to hold financial assets to collect contractual cash flows, an entity needs to consider the frequency and significance of past sales activity (and the reason for those sales) as well as expectations about future sales activity.
- 3.10 For newly originated or newly acquired financial assets, the entity needs to consider information about how cash flows were realised in the past as this will then affect the classification of new assets recognised in the future.
- 3.11 The business model is a matter of fact and not merely an assertion⁵. It is based on an assessment of the facts that can be observed through the activities that the entity undertakes to achieve the objective of the business model. An entity's business model is not therefore a choice and does not depend on management's intentions for an individual instrument for the purposes of the classification and measurement approach of IFRS 9.

Determining the level at which the business model is assessed

- 3.12 An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The business model does not depend on management's intentions for an individual instrument.⁶

⁴ IFRS 9, Appendix B application guidance, paragraph B4.1.2B

⁵ IFRS 9, Appendix B application guidance, paragraph B4.1.2B

⁶ IFRS 9, Appendix B application guidance, paragraph B4.1.2

- 3.13 An entity's management needs to apply judgement to determine at what level the business model condition is applied. For example, it may be assessed on a portfolio basis or a business unit basis. The determination should be made based on how an entity manages its business and not made at the level of an individual asset – i.e. on an instrument-by-instrument basis.
- 3.14 Ultimately the level at which the business model assessment is made is the level at which decisions are taken about how an entity manages its financial assets. The business model assessment may result in different objectives at different levels within the same consolidation group.
- 3.15 For example, if an entity has a business model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows. However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be managing this portfolio to collect the contractual cash flows.⁷

Reclassification of financial assets

- 3.16 If cash flows are realised in a manner that is different than expected at the date the business model was assessed then this will not give rise to a prior period error (under IAS 8), nor will it change the classification of the remaining financial assets held in the extant business model, provided all relevant information was considered at the time of the business model assessment.
- 3.17 Reclassification of financial assets is not prohibited under IFRS 9, however, changes in the business model are expected to be very infrequent, determined by the entity's senior management because of external or internal change and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line.⁸
- 3.18 The Standard mandates that reclassifications should take effect from the beginning of the following reporting period. This is to prevent entities from choosing a reclassification date to achieve specific accounting effects.

Applying the business model in the public sector

- 3.19 The government's policy position is to ensure the effective and efficient management of publicly owned assets and keeps ownership of all assets under review. Where there is no longer a strong policy reason for continued

⁷ IFRS 9, Appendix B application guidance, paragraph B4.1.4A, Example 3

⁸ IFRS 9, Appendix B application guidance, paragraph B4.4.1

public ownership or where there is potential for an asset to operate more sensibly and efficiently in the private sector, the government will continue to consider the potential sale of public sector assets.

- 3.20 The classification approach under IFRS 9 is based on how an entity manages its financial assets. The business decision for originating or acquiring financial assets in the first instance is not relevant to the ongoing management of these financial assets.
- 3.21 In the public sector the business motivation or policy intention for originating or acquiring financial assets is not relevant to the IFRS 9 assessment of the business model. This is because the assessment is based around the management of the financial assets - i.e. holding to collect contractual cash flows, selling financial assets or both - and not the rationale for originating or acquiring the financial assets. The business motivation or policy intention is only ever relevant to the extent that it impacts upon the management of the financial assets.

Determining the level at which the business model is assessed in the public sector

- 3.22 Entities will need to consider who is taking meaningful decisions about how financial assets are managed to assess the business model for classification and measurement. How and why assets are originated in the first instance is not relevant in this assessment.
- 3.23 Furthermore, it is worth considering that different business models may be in place for distinct assets or groups of assets under common management. A single and consistent business model is not necessarily required for all assets or groups of assets managed by the same people.
- 3.24 Where the public sector is likely to be slightly nuanced from the private sector is the likelihood of different business models within different public sector entities under common control. In the private sector, it may be expected that the approach across a consolidation group would need to be consistent. Then by analogy in the public sector there may be the expectation that a consistent approach to the assessment of the business model should be taken across the whole public sector.
- 3.25 But the public sector is unique in that each entity, specifically each Accounting Officer, is separately accountable to Parliament. In addition, non-departmental public bodies (NDPBs) are organisations that sit at 'arm's-length' from ministers and have varying degrees of operational autonomy and independence from ministers.⁹

However, it should be noted that the business model assessment carried out by public sector entities to determine what their business model actually is – i.e. the approach taken - will be the same as in the private sector.

⁹ <https://www.gov.uk/guidance/public-bodies-reform>

Applying changes to the business model in the public sector

- 3.26 IFRS 9 notes¹⁰ that a change in intention is not a change in business model. The Standard is clear that when, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets¹¹.
- 3.27 Changing the business model is likely to be a significant event and it would be expected that decision makers engage in substantive discussions and investigations into alternatives before a decision is finalised. No disclosures would be required in the entity's financial statements until the decision has been made by senior management, committed to and communicated internally. This is consistent with IFRS 7 which requires the relevant disclosures to be made after the reclassification has occurred. Even from an IAS 1 Presentation of Financial Statements' perspective, the business model would still need to have changed.
- 3.28 IFRS 9's application guidance provides the following example of a change in business model:
- An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
- 3.29 The above example illustrates that where an entity is acquiring a new business, and therefore would have to put a significant amount of planning and resources into the acquisition, the entity probably knew because of the planning it would change its business model following the acquisition. Consequently, the business model would not change until the new business was acquired.
- 3.30 Applying the above to a public sector context, it is only likely that an entity's business model should be re-examined after an announcement of a significant change in policy (i.e. change in intention) has been made publicly and there is evidence of a resulting influence on the way a class of financial assets are being managed. The Standard could be applied in such cases without adaptation or interpretation for the public sector context. The public sector should not be reporting based on anticipated future changes in policy and any anticipated changes in regulatory approach should also not be considered in the assessment.

¹⁰ IFRS 9, paragraph B.4.4.3

¹¹ IFRS 9, paragraph 4.4.1

Interpreting 'contractual cash flows' in the public sector context

- 3.31 In the public sector context, there may not be clear or easily identifiable contractual arrangements¹² in place upon the origination of some financial assets, for example, when student loans are provided through the student loan support system or when interest-free loans are provided to benefits with repayments made as deductions from future benefits entitlement.
- 3.32 IFRS 9 does not define what 'contractual' means within the scope of the Standard. There is continuity in this regard as IAS 32 Financial Instruments: Presentation is still applicable, with some amendments, when IFRS 9 becomes effective.
- 3.33 The definition of a financial instrument under IAS 32 is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity¹³. It clarifies that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing¹⁴.
- 3.34 Under IAS 39, if a debt instrument has been accounted for at AC, or as an available-for-sale financial asset, then entities are already required to consider the contractual cash flows to apply the effective interest rate method and to establish if there are any embedded derivatives.
- 3.35 The IFRS 9 classification assessment should not unduly impact public sector entities when determining whether contractual cash flow characteristics exist within the scope of the Standard. IFRS 9 does necessitate the need for entities to think differently about the information they already have; there is likely to be some form of a contract or other relevant documentation, such as the terms and conditions of a loan, which can be utilised in considering the contractual cash flows.

¹² Statutory obligations are not financial liabilities and are therefore outside the scope of IAS 39 or IFRS 9 – International GAAP 2016

¹³ IAS 32, paragraphs 11

¹⁴ IAS 32, paragraphs 13

Chapter 4

The simplified approach to impairment

- 4.1 This approach is either required or available as a policy choice for trade receivables, contract assets and lease receivables:
- For short-term trade receivables, an entity should always (mandatory) recognise a loss allowance for an amount equal to lifetime ECLs. This also applies to long-term receivables that do not contain a significant financing component in accordance with IFRS 15 Revenue from Contracts with Customers.
 - For other long-term trade receivables, contract assets and lease receivables, an entity can choose an accounting policy to recognise a loss allowance at an amount equal to lifetime ECLs.
- 4.2 This approach simplifies the application of the impairment model as it removes the need for an entity to consider whether the credit quality of these financial assets has deteriorated significantly since initial recognition. It may, however, result in a more sizeable loss allowance recognised on 'day-1' than for the same receivables had they been impaired under the full IFRS 9 impairment model.
- 4.3 IFRS 9 does not prescribe how an entity should estimate lifetime ECLs when applying the simplified model. The Standard does however permit the use of practical expedients and the Standard's application guidance refers to an example of a provision matrix¹ being used to calculate the expected losses on trade receivables. It is anticipated that this approach will be widely applied in the private sector.
- 4.4 There is no 'one size fits all' approach to this: each entity will need to consider its own circumstances, including the materiality of expected losses and the data available (without undue cost or effort). In devising such a provision matrix, an entity is likely to use its historical credit loss experience (modified to reflect current as well as the forecast economic conditions) for trade receivables to estimate the 12-month ECLs or the lifetime ECLs on the relevant financial assets.
- 4.5 A total of £154.7 billion of trade and other receivables were disclosed in the 2015-16 WGA². The application of the simplified approach to impairment is likely to suit those entities that only have receivable balances. To reduce application issues, streamline implementation and improve comparability across the public sector, the Standard has been interpreted for the public

¹ IFRS 9 Application guidance, paragraph B5.5.35

² <https://www.gov.uk/government/publications/whole-of-government-accounts-2015-to-2016>

sector context and the following accounting policy has been mandated with regards to the simplified approach to impairment:

- The accounting policy choice allowed under IFRS 9 for long term trade receivables, contract assets which do contain a significant financing component (in accordance with IFRS 15), and lease receivables within the scope of IAS 17 has been withdrawn and entities should always recognise a loss allowance at an amount equal to lifetime ECLs. All entities applying this Manual should utilise IFRS 9's simplified approach to impairment for relevant assets.
- 4.6 Utilising this approach would remove the need for a constant assessment for impairment but is likely to result in a significant 'day-1' loss.
- 4.7 It should also be noted that the FReM includes the following adaptation of IFRS 15 for the public sector context, as set out in FReM Chapter 6:
- The definition of a contract is expanded to include legislation and regulations which enables an entity to obtain revenue that is not classified as a tax by the Office of National Statistics. The costs of preparing the legislation or regulations does not amount to assets under IFRS 15 (91-94).
- 4.8 For non-tax revenue (such as fees, charges and levies) the definition of a contract is expanded to include legislation or regulations; providing the ability for the entity to impose a charge on the customer and the requirement for the customer undertaking the relevant activities to be liable to pay the charge. The existence of such legislation/regulations and the practice of the government imposing the fee, levy or charge is deemed akin to customary business practices. The legislation would also provide the enforceability of the obligations on both parties. HM Treasury's IFRS 15: application guidance³ provides an illustrative example of this intent.
- 4.9 Therefore, public sector reporting entities that recognise contract assets within scope of IFRS 15 (and the associated FReM adaptation) will also need to assess their contract assets for impairment in accordance with IFRS 9 and recognise loss allowances for ECLs on these relevant assets.
- 4.10 An impairment of a contract asset shall be measured, presented and disclosed on the same basis as a financial asset that is within the scope of IFRS 9.⁴ IFRS 15 requires an entity to disclose any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from impairment losses from other contracts, for the reporting period unless those amounts are presented separately in the Statement of Comprehensive Income (SoCI) in accordance with other Standards.⁵

³ <https://www.gov.uk/government/publications/government-financial-reporting-manual-application-guidance>

⁴ IFRS 15, paragraph 107

⁵ IFRS 15, paragraph 113(b)

Chapter 5

Intra-government balances

- 5.1 HM Treasury considered the value of calculating impairment allowances on intra-government balances, specifically whether there is a genuine risk of default or if the calculation is purely an accounting adjustment.
- 5.2 Debate within the IFRS 9 technical working group and the FRAB covered:
- reconciling the impairment model with extant legislation which prevents some large government loan books from making losses;
 - how the absence of past default does not necessarily mean no risk of future default;
 - examples of riskier - i.e. not risk free - public sector organisations;
 - the concept of materiality when calculating material credit risk; and
 - providing useful disclosures to inform the user of the accounts.
- 5.3 The complication of eliminating intra-government balances when impairment models differ between public sector bodies was also considered; even though this issue is not unique to the public sector and would be something the private sector and consolidating parent entities would also need to contend with.
- 5.4 HM Treasury provided the FRAB with a range of options on where a boundary could be drawn to apply an impairment exemption in the public sector. The IFRS 9 technical working group assessed and debated the practicalities of applying two different options:
- Balances with central government core departments and central funds being exempt from the new impairment model; and
 - All entities within departmental consolidation boundaries and central funds being exempt from the new impairment model.
- 5.5 HM Treasury and the FRAB concluded that some sort of exemption was required as a minimum but that it would not be appropriate to apply the exemption unilaterally to all entities within consolidation boundaries due to instances of subsidiaries within departmental boundaries having different credit ratings to the sponsor department.
- 5.6 Therefore, to improve consistency across the public sector and to better facilitate the consolidation of public sector entities within the WGA, the Standard has been adapted for the public sector context with the following being mandated:

- Balances with core central government departments (including their executive agencies), the Government's Exchequer Funds¹, and the Bank of England are excluded from recognising stage-1 and stage-2 impairments. In addition, any Government Exchequer Funds' assets where repayment is ensured by primary legislation are also excluded from recognising stage-1 and stage-2 impairments. ALBs are excluded from the exemption unless they are explicitly covered by guarantee given by their parent department; and
- Liabilities with core central government departments (including their executive agencies), the Government's Exchequer Funds, and the Bank of England are assessed as having zero 'own credit risk' by the entities holding these liabilities.

¹ Government's Exchequer Funds include: the National Loans Fund; all Consolidated Funds; the Contingencies Fund; the Exchange Equalisation Account; the Debt Management Account; the Public Works Loan Board; and Commissioners for the Reduction of the National Debt.

Chapter 6

Presentation and disclosures

- 6.1 IFRS 9 introduces new presentation requirements by amending IAS 1 to require new line items to be presented in the PoL section of the SoCI including separate presentation of interest revenue calculated using the effective interest method, gains and losses arising from the derecognition of financial assets measured at AC and impairment losses (including reversals) determined in accordance with IFRS 9.
- 6.2 It also amends IFRS 7 to introduce extensive new and amended disclosures. Some of the amendments to the IFRS 7 disclosures reflect the new classifications under IFRS 9. The changes also require an increased granularity of information presented.
- 6.3 There are also new disclosures to reflect substantial decisions taken by entities under IFRS 9, for example, there are new disclosures about investments in equity instruments designated at FVOCI, new and amended disclosures on those financial instruments designated at FVTPL and new disclosures required when an entity takes a decision to reclassify its financial assets following a change in its business model. There are disclosures on risk management activities (particularly as they relate to hedge accounting) and for hedge accounting, and disclosures on credit risk management and impairment.
- 6.4 The disclosures for the new impairment model are substantial. IFRS 7 requires that a reporting entity disclose information to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this, objective detailed disclosures are required to provide:
- information about credit risk management practices and how they relate to the recognition and measurement of ECLs, including the methods, assumptions and information used to measure ECLs;
 - information, both quantitative and qualitative, about ECLs including a reconciliation of changes in the amount of ECLs and the rationale for those changes; and
 - information about an entity's credit risk exposure (including where there is significant credit risk abundance or concentrations).
- 6.5 IFRS 7 already requires disclosure of the amount of the change in fair value that is attributable to changes in the credit risk of the liability. Consequently, some entities already calculate the information necessary to present the effects of changes in liabilities' credit risk in OCI.

- 6.6 The concept of materiality, as it applies to disclosures, is fundamental. It is not appropriate to simply apply the disclosure requirements in IFRS 9 without considering materiality. Specific disclosures are not required under IFRS if the information resulting from that disclosure is not material. Care should be taken to not reduce the understandability of the financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures and functions. The materiality concept should also be applied on a disclosure-by-disclosure basis.
- 6.7 HM Treasury considers it appropriate to retain the disclosure requirements of IFRS 9 in full but to emphasise the materiality considerations that entities are expected to undertake in determining whether they are required to provide particular disclosures.

Chapter 7

The whole of government accounts

- 7.1 Implementation of IFRS 9 presents some challenges to the WGA. Disclosures in the WGA will require more detail in the transition year to allow users of the financial statements to understand the impact of IFRS 9 implementation. Post-implementation disclosures will require more information on significant events that lead to impairments in financial assets being recognised.
- 7.2 Supplementary data may need to be collected as part of the transition process, particularly to support adjustments to opening balances, and to demonstrate that IFRS 9 has been implemented in a materially consistent fashion across the WGA.
- 7.3 IFRS 9 implementation increases the complexity of eliminating intra-government transactions. This will particularly impact where counterparties have valued the same transaction differently. The data collection and accounts preparation process will require changes to address this issue.
- 7.4 Further analysis will be carried out to identify those components with significant financial instrument portfolios. Specific engagement will be undertaken with those organisations prior to implementation. Further information and guidance will then be provided at a later stage, using the public and private sector experiences to tailor the WGA approach.

Chapter 8

Impact on budgets and Estimates

- 8.1 Discussions with the ONS indicate that IFRS 9 is broadly aligned with the National Accounts treatment. However, the introduction of IFRS 9 is likely to have the most material impact on departments with financial instruments subject to impairment accounting. Consequently, these departments' non-cash AME budgets will be affected due to the introduction of 'day-1' loss allowances under the new impairment methodology. Those departments with significant financial instrument portfolios are likely to be significantly impacted by the recognition of losses brought forward with a substantial effect in the first year of implementation.

Budgets

- 8.2 When IFRS 9 is introduced, the budgeting treatment for financial instruments is expected to be as consistent as possible for debt instruments across the board and equity instruments across the board, irrespective of the determined financial reporting treatment. For example, all stages of the IFRS 9 impairment model will impact non-cash AME budgets.
- 8.3 The budgeting treatment for financial instruments will be promulgated in the Consolidated Budgeting Guidance (CBG)¹ in the normal manner.

Estimates

- 8.4 Where there is a change in accounting standards there is no net impact on budgets and the Supply sought at the time was correct. Parliament is therefore content not to see a Prior Period Adjustment (PPA) on the voted part of the Estimate (i.e. Part I, Part II).
- 8.5 However, Parliament does require departments to identify the change due to adopting a new accounting standard and the impact on prior years in the 'Note F to an Estimate - Accounting Policy changes'. Further details can be found in paragraphs 3.39 – 3.40 of the Supply Estimates: a guidance manual about the content of Note F, which can be found on gov.uk."
- 8.6 As this change in accounting standard will be made across the public sector, HM Treasury will provide a common statement and narrative to be included in the 2018-19 Main Supply Estimates, explaining the change, in 'Note F to an Estimate – Accounting Policy changes' for those departments with financial instruments.

¹ The 2018-19 CBG will be circulated to departments for comment prior to publication in early 2018.