HM TREASURY

Financial Reporting Advisory Board Paper

IFRS 9 *Financial Instruments* – Transition arrangements and considerations

Issue:	A paper was presented to the Board at the last FRAB in March 2015 introducing the Relevant Authorities' high level work plan for the adoption and implementation of IFRS 9 in the public sector. The Board agreed with the approach proposed but commented that the initial focus of the project should be on transition arrangements and the various options. This paper, by the Treasury, provides a summary of the options and requirements of the Standard regarding transition. It also includes a summary of concerns raised by some central government entities that have provided intital views on the likely impact to their financial statements. The Treasury seeks initial views from the Board on the various options for transition and to provide comment on the considerations raised.
Impact on guidance:	The considerations outlined in this paper, and the Board's view will help inform consultations over the summer.
IAS/IFRS adaptation?	None proposed at this stage. This will be considered in a later paper to the Board.
Impact on WGA?	None at this stage, but decisions on transition will affect how IFRS 9 is applied in WGA
IPSAS compliant?	IPSASB have yet to consider IFRS 9.
Interpretation for the public sector context?	This will be revisited nearer implementation date and in a later paper to the Board.
Impact on budgetary regime?	Without adaptation, the Standard does have an impact on departmental budgets.
Alignment with National Accounts	The Treasury is examining IFRS 9 against ESA10 National Accounts framework as this will be applicable at the time when the Standard becomes effective.
Impact on Estimates?	Without adaptation, the Standard may have an impact on the Estimates' process.
Recommendation:	The Treasury seeks initial views from the Board on the various options for transition and to provide comment on the considerations raised.
Timing:	No changes are expected to be made to the FReM until the 2018/19 financial year.

DETAIL

Background

1. IFRS 9 *Financial Instruments* as issued by the IASB in July 2014 supersedes all other prior versions of IFRS 9. The standard is effective for annual periods beginning on or after January 2018, with earlier adoption permitted. Whilst the Standard must be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* the Standard contains specific transition requirements.

2. There are a number of considerations to evaluate as a part of the transition from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9. These include the transition arrangements around retrospective application (and the associated reliefs) and other transition considerations. These transition arrangements need to be assessed whilst implementing the Standard's three phased approach of classification and measurement of financial instruments, impairment methodology, and hedge accounting.

3. <u>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</u>. 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;
- designating or revoking designations for financial instruments as at fair value through profit or loss;
- designating investments in equity instruments that are not held for trading as at fair value through other comprehensive income;
- 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 other comprehensive income would create or enlarge an accounting mismatch in profit or loss – i.e. an entity will need to determine whether offsetting assets treated at fair value through other comprehensive income would increase the volatility within profit or loss due to the liabilities impacting profit or loss;
- 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.

Transition arrangements

4. 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

5. IAS 8 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 particular circumstances.

6. 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 *Financial Instruments: Disclosures* 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.

7. Prior periods may, however, be restated if it is possible to do so without the use of hindsight. If an entity restates prior periods, the restated financial statements must exhibit all the requirements of IFRS 9.

Transitional reliefs for retrospective application

8. 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.

9. 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 these requirements are not taken into account in the assessment of the solely payments of principal and interest (SPPI) condition.

10. 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 a large number of financial assets that were previously measured at fair value but are measured at amortised cost 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.

11. If the restatement approach is adopted, under IFRS 9 the entity is to use the fair value of the financial asset/liability at the end of each reporting period presented as the gross carrying amount of the asset or amortised cost of the liability. Additionally, the fair value of the asset/liability at initial application date of IFRS 9 will become the new gross carrying amount or new amortised cost. The previously determined fair value information will identify whether a financial asset was impaired in comparative periods.

12. 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

13. IFRS 9 requires an entity to assess whether the objective of an entity's business model, on the basis of circumstances at the date of initial application, is to manage financial assets to collect the contractual cash flows. Financial instruments are classified and measured via amortised cost or fair value, with the resulting designation and classification of financial assets (or equity instruments) 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 on the basis of circumstances when the instrument first satisfied the recognition criterion in IAS 39.

14. 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 in paragraph 16 below) because the underlying classification and measurement approach has not changed.

15. 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 type of instruments to be accounted for as fair value through profit or loss. Consequently, an entity should reconsider at transition its original assessment of whether to designate a financial asset or financial liability at fair value through profit or loss.

16. 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 (as discussed in paragraph 3 above) then an election to designate any financial asset/liability as at fair value through profit or loss may be made. It should be noted that any previous designation of a financial liability at fair value through profit or loss may only be revoked if the liability was originally designated on the basis of the accounting mismatch criterion.

17. An entity is required to assess whether presenting the effects of changes in a liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss- on the basis of 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.

18. 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, if the entity restates prior periods.

19. Hybrid financial liabilities previously designated as fair value through profit or loss 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 as a result of designation of fair value through profit or loss or revocation is applied retrospectively.

Impairment methodology

20. 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.

21. 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. If this is not possible, an entity is to recognise a loss allowance equal to lifetime expected credit losses 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 expected credit losses is met when payments are more than 30 days past due) on transition.

Hedge accounting

22. 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 will apply to all hedging relationships.

23. Restatement of comparative period financial statements occurs 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 are measured at fair value at the date of initial application. 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

24. IFRS 9 introduces the need for additional data to support both methodology and disclosure requirements. For example, the first stage 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.

25. New infrastructure (such as developing new processes, systems and controls) may be needed to ensure entities are able to run the existing IAS 39 and IFRS 9 models concurrently. This is likely to only be necessary for entities with a significant amount of financial instruments (or complex instruments). There are likely to be further costs arising from educating preparers on the requirements of the Standard.

26. 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.

27. 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 fair value through other comprehensive income presentation alternative at the date of initial application.

28. The transition provisions of IFRS 9 (2014) 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 them on transition and business as usual thereafter.

Initial high level views of central government entities

29. On the 5th May 2015 the Treasury issued a letter to Finance Directors inviting them to provide high level comment and views on the impact of the Standards. The Treasury received nine responses to this letter. Consistent themes in the responses were concerns over the impact of the Standard on loan books and financial guarantees, the effects of impairment of debt and the reclassification of 'held to maturity', 'loans and receivables' and 'available for sale' instruments. There were three responses regarding derivatives and forward contracts and the respondents emphasised the need to carefully consider the implications of IFRS 9 for these activities. Only one respondent expressed concern over the treatment of embedded derivatives and one respondent also highlighted the need for internal risk management frameworks to manage risk and exposure.

Options

30. At the March 2015 Board meeting it was noted that an early decision is needed on the transition approach for IFRS 9 and that a blanket approach to transition would make the work plan less complicated.

31. There are two key options for transition to IFRS 9:

a) An initial application date with restatement and calculation of prior year comparatives including IFRS 9 disclosure requirements on transition

32. It may be beneficial to produce comparative financial statements on a restated basis as: the presentation of restated comparative financial statements is consistent with IAS 8; there is sufficient time for entities to prepare restated comparative financial statements before the effective date; and IAS 39 and IFRS 9 are sufficiently different from each other so restatement may be necessary to provide meaningful information around transition to the users of the financial statements.

33. Conversely, comparability may be somewhat impaired by the transition requirements, which are complex and lack consistency which may diminish the effectiveness of the comparative information. For example, the classification and measurement stage requires retrospective application with some transition reliefs, whereas the hedge accounting stage requires prospective application. There is also a risk that the exceptions to full retrospective application may result in restated information being less than complete. The partial restatement of comparative financial statements may not improve users understanding of performance in prior periods (on a consistent basis).

34. Feedback provided to the IASB's '2011 Mandatory Effective Date Exposure Draft' on the preferred approach to understanding the effect of the transition to IFRS 9 noted that the statement of profit or loss and other comprehensive income (and restatement of it in comparative periods) is less important to user analysis than the statement of financial position, excluding situations where it allows for a link to the statement of financial position (for example, net interest income). Furthermore, where restatement means largely the presentation of historical fair value changes, comparative information is less useful to users as extrapolation is not possible in the same way as it is for amortised cost information.

35. This approach may increase the volatility of prior period impairments due to the restatement exercise of treating the fair value at each past reporting date as the gross carrying amount for financial assets and the amortised cost for financial liabilities.

36. If the restatement approach is applied then IAS 1 *Presentation of Financial Statements* may also apply and so a third statement of financial position may need to be presented when an accounting policy is applied retrospectively and there is a material effect as a result of the change.

37. 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.

b) An initial application date with no restatement but additional IFRS 9 modified transitional disclosure requirements

38. If an entity elects not to restate comparative periods, quantification of adjustments is still necessary in order to determine the transition adjustment in the opening balances in reserves/other components of equity, as appropriate; 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.

39. Modified transition disclosures are required instead of the restatement of comparative financial statements, if this is the approach chose by the entity. Additionally, this approach removes the burden on entities from having to calculate comparatives.

40. IFRS 7 includes modified transition disclosure requirements that focus on changes in the statement of financial position at the date of initial application of IFRS 9 and also focus on the effect on the key financial statement line items for the current period. These may be useful to allow users of financial statements to assess the effect of transition to IFRS 9.

41. 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, entities are already calculating the information necessary to present the effects of changes in liabilities' credit risk in other comprehensive income. However, this isn't expected to be a widespread issue for central government or the public sector in general.

Recommendation

42. The Treasury seeks the views of the Board on the various options for transition and ask the Board to provide comment on the following:

- Is a mandated blanket approach across entities the most sensible or should transition options (a) or (b) to the new Standard be at the discretion of the entity?
- Should various retrospective application treatments be prescribed as part of a blanket approach to introduction or should these decisions be left to the discretion of the entity to take into account differing circumstances?
- Is more than one date of initial application feasible or should all public sector entities adopt the Standard in full with the same initial application date?

- Which is the most suitable approach for the public sector context - the calculation of comparatives (restatement) or additional modified transitional disclosures?

- Should there be a consistent, mandated, approach across entities to hedge accounting?

43. Do the Board have any comments, to help shape the discussions of the technical working group, on the other transition considerations raised in this paper?

HM Treasury
18 June 2015