Financial Reporting Advisory Board Paper

IFRS 9 Financial Instruments

Issue:	The IASB has issued IFRS 9 which will replace IAS 39 for accounting periods starting on or after 1 January 2015. IFRS 9 has been developed in stages and remains incomplete. It is likely the full standard may take some years to complete. This paper considers the key points from IFRS 9 as it currently stands and some initial high-level views of the potential implications for central government entities.
Impact on guidance:	No impact at this stage.
IAS/IFRS adaptation?	None proposed at this stage.
Impact on WGA?	Not at this stage.
IPSAS compliant?	No IPSAS is based on IAS 39.
Interpretation for the public sector context?	This will be revisited nearer implementation date as the Standard develops.
Impact on budgetary regime?	Impact will depend on the final requirements of IFRS 9 and ESA 10.
Alignment with National Accounts	HM Treasury is examining IFRS 9 against the ESA10 National Accounts framework as this will be applicable at the time when the standard becomes effective.
Impact on Estimates?	Impact will depend on the final requirements of IFRS 9 and ESA 10.
Recommendation:	That the Board note the key differences in accounting treatment between IAS 39 and IFRS 9 as it currently stands.
Timing:	No changes are expected to be made to the FReM until the 2015/16 financial year.

DETAIL

Background

1. The IASB has been developing IFRS 9 in stages:

- Classification and measurement;
- Hedge accounting; and
- Impairment.

2. The current standard covers classification and measurement and is effective for periods starting on or after 1 January 2015. This paper does not consider the further changes to classification proposed in the Exposure Draft issued by the IASB in November 2012 'Classification and Measurement: Limited Amendments to IFRS 9'.

3. In addition this paper does not consider the hedge accounting and impairment stages of the Standard yet to be released. Hedge accounting is expected to be issued in 2013 but the impairment stage has no target date for issue published. The IASB is deliberating further on the impairment phase and companies, in particular banks, are likely to require further time to implement any new requirements hence this may cause the effective date of IFRS 9 to be pushed back later than 1 January 2015.

4. Early adoption is permissible (subject to EU endorsement for EU reporters) but this will not apply for central government. For organisations adopting IFRS 9 for reporting periods beginning on or after 1 January 2013, revised disclosures will need to be made but prior periods will not need to be restated.

5. IFRS 7 requires organisations to disclose changes in categories of financial instruments as a result of IFRS 9 and the financial impact of the changes.

6. The Standard has not been endorsed by The European Union to date. The European Financial Reporting Advisory Group (EFRAG) has considered the Standard and the November 2012 Exposure Draft but has expressed concerns on the Standard specifying a mandatory effective date when large elements of the Standard are still outstanding and specific concerns relating to the insurance industry.

Impact on Financial Statements

7. IFRS 9 has reduced the number of classifications for financial instruments.

Assets	
IAS 39	**IFRS 9 categories**
Loans and Receivables	Amortised Cost
Fair Value through Profit and Loss	Fair Value through Profit and Loss (FVTPL)
Available for Sale	Fair Value through Other Comprehensive Income (only for equity investments)
Held to Maturity	
Liabilities	
Amortised Cost	Amortised Cost
Fair Value through Profit and Loss	Fair Value through Profit and Loss

Assets

8. All Financial Instruments will be recognised initially at fair value which is no change compared to IAS 39 but as stated the number of categories have reduced. Assets will then be subsequently measured at fair value or amortised cost. Assets will only be held at amortised cost if they pass the:

- ***Business Model Test***; the asset is held in a business model to collect the contractual cash flows; and

- ***Cash Flow Test***; the cash received comprises of principal and interest only (ie the asset has basic loan features).

9. Assets passing both of these tests can only be measured at fair value through profit and loss if this means eliminating or significantly reducing an accounting mismatch (e.g. against a derivative or financial liability related to the asset is measured at FVTPL) and this decision would be irrevocable.

10. Any equity investments will need to be held at fair value through profit and loss. However an organisation may make an irrevocable election to take fair value gains and losses through other comprehensive income rather than income and expenditure. Under this classification dividend income is recognised in profit or loss. Fair value gains or losses accumulated in equity are not recycled to profit or loss on disposal. This option is not available for assets held for trading.

11. For financial assets, embedded derivatives no longer need to be assessed and separated out if they are not closely related. Instead the cash flow test applies to the asset in its entirety and the asset may be required to be measured at fair value as a whole.

12. The Annex shows the major differences in accounting treatment for significant types of financial assets under IFRS 9 compared to IAS 39.

13. As a result of IFRS 9 some organisations will hold more assets at FVTPL and some less. For instance investments that are quoted in an active market can now potentially be held at amortised cost rather than FVTPL whereas private equity investment will now be held at FVTPL. However, in some limited cases cost may be used as an approximation to fair value where there have been no:

- significant change in the performance of the investee compared with budgets, plans or milestones;
- changes in expectation as to whether the investee's technical product milestones will be achieved;
- a significant change in the market for the investee's equity or its products or potential products;
- a significant change in the global economy or the economic environment in which the investee operates;

- a significant change in the performance of comparable entities, or in the valuations implied by the overall market;

- internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy; and

- evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

14. Under IFRS 9 many government financial assets would be held at amortised cost such as receivables and straight forward loan investments held for the long term. Other more complex financial instruments would need to be considered carefully and may need to be held at fair value, even where no recognised market exists, with gains and losses taken through Profit and Loss, this would include all equity investment.

15. Government hold a wide variety of investments, some of them complex. IFRS 9 has practical implications in terms of valuation, particularly for assets where no recognised market exists. Departments may be required to obtain up to date valuations for financial statements and estimates for assets held at fair value under IFRS 9 that are currently held at cost. There would be cost implications to obtaining these valuations. The volatility in valuations of assets held at fair value through profit and loss would present an additional challenge for estimates. Departments would need to consider carefully and factor in potential adverse impacts of valuations for estimates.

Liabilities

16. The main principles for liabilities are the same under IFRS 9 as IAS 39 (e.g. the embedded derivative requirements and guidance remains for financial liabilities). Liabilities are recognised initially at fair value.

17. For changes in value of liabilities designated under the fair value option and held at FVTPL, fair value changes due to changes in the organisation's own credit risk are taken directly to other comprehensive income unless this creates or increases an accounting mismatch. This amount is not recycled when the liability is settled or extinguished. This is unlikely to impact on central government organisations.

Other

18. Embedded derivative requirements for non-financial contracts is retained (i.e. non-financial contracts must continue to be assessed for the existence of non-closely related embedded derivatives).

19. The derecognition requirements of IAS 39 have been carried over to IFRS 9 without change.

IPSAS compliance

20. IPSAS 29 relates to Financial Instruments; Recognition and measurement. This is drawn primarily from IAS 39 so it does not reflect the changes brought in with IFRS 9. The IPSASB work plan indicates that an exposure draft on updates to IPSAS 29 will be issued September 2013.

Proposed text for the Government Financial Reporting Manual

21. At this stage no text is proposed for Government Financial Reporting Manual.

Impact on the budgetary regime

22. Impact on the budgetary regime will depend on the final requirements of IFRS 9 and ESA 10. If the Standard were adopted without adaptation in its current form, we envisage that annual gains and losses for assets and liabilities held at Fair Value through Profit and Loss are likely to impact on budgets. The Consolidated Budgeting Guidance specifies specific treatment for changes in value of debtors, but for other financial instruments budgeting treatment reflects Departmental Accounts and scores against AME.

Summary and recommendation

23. The Board is asked to note the key points from IFRS 9. It is important that further amendments to the Standard are monitored so that all implications for the public sector are considered carefully and in advance of European Union endorsement.

HM Treasury
24 May 2013

ANNEX

Comparison of subsequent measurement of financial assets under IAS 39 and IFRS 9

Type of Financial Instrument	Accounting Treatment under IAS 39	Accounting Treatment under IFRS 9
Loans and Receivables	Amortised cost with gains and losses through profit and loss.	No change as long as the 'business model' and 'cash flow characteristics' tests are met. Otherwise fair value through profit and loss.
Investments in equity instruments	Often classified as 'available for sale' with gains and some losses deferred in other comprehensive income. Impairment losses recognised in profit or loss. Equity instruments that do not have an active market and whose fair value cannot be reliably measured are valued at cost.	Measured at fair value with gains/losses recognised in profit or loss, unless designated at fair value through other comprehensive income in which case only dividends recognised in profit or loss. Applies to equity instruments that do not have an active market.
Available for sale debt instruments	Recognised at fair value with gains/losses deferred in other comprehensive income. Impairment losses and reversals recognised in profit and loss.	May be measured on amortised cost basis if the 'business model' and 'cash flow characteristics' tests are met, otherwise measured at fair value through profit and loss.
Embedded derivatives	Components considered separately and recognised at fair value.	Asset considered as a whole. Unlikely to pass 'cash flow characteristics test' so measured at fair value with gains and losses through profit and loss.

Held to maturity investments	Measured at amortised cost.	Only measured at amortised cost if both 'business model' and 'cash flow characteristics' tests are met. Otherwise measured at fair value through profit and loss.