Financial Reporting Advisory Board Paper

IFRS 9 Financial Instruments

Issue:	The IASB has issued the final version of IFRS 9 which will replace IAS 39 for annual periods beginning on or after 1 January 2018, but early adoption is permitted. In May 2013 [FRAB (117) 05] a paper was provided to the Board considering the key points of the Standard and some initial high-level views of the potential implications for central government entities. This paper provides an update based on the final version of the Standard, which combines classification and measurement, the *expected* credit loss impairment model and hedge accounting. HM Treasury ask that the Board note the finalisation of IFRS 9 and seek their early views on the potential public sector implications.
Impact on guidance:	No impact at this stage.
IAS/IFRS adaptation?	None proposed at this stage. This will be considered in a later paper to the Board. IAS 39 has been interpreted for the FReM: Where a department has an investment in another public sector entity that has not been designated for consolidation, it should be reported following the requirements of IAS 39. This includes all interests in bodies classified as public corporations by the ONS, which are within the scope of Managing Public Money principles. In addition, 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 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 (currently 2.2%) as applied to the flows expressed in current prices.
Impact on WGA?	Not at this stage.
IPSAS compliant?	Not consistent with IPSAS.

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:	HM Treasury ask that the Board note the finalisation of IFRS 9 and seek their early views on the potential public sector implications.
Timing:	No changes are expected to be made to the FReM until the 2018/19 financial year.

DETAIL

Background

1. The IASB has developed IFRS 9 in phases. It was first issued in 2009 with a new classification and measurement model for financial assets, which was followed by additions in 2010 relating to requirements for financial liabilities and derecognition. In 2013, the Standard was amended to include the new hedge accounting model. It was finalised in July 2014 with the final version of the Standard, superseding all previous versions.

2. IFRS 9 was expected to be applied from 1 January 2015, however, this has now changed and has been delayed to 1 January 2018. It is to be applied retrospectively subject to transitional reliefs, for example, an option not to restate prior periods. This paper considers the complete version of IFRS 9 including hedge accounting and impairments which were not discussed within the previous paper (May 2013) presented to the Board.

3. The objective of IFRS 9 is to provide users with more useful information about an entity's *expected* credit losses at all times and to update the amount of *expected* credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments.

4. Early adoption of IFRS 9 is permissible (subject to EU endorsement for EU reporters) but this will not apply for central government. 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).

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. IFRS 7 disclosure requirements regarding valuation techniques have been relocated to IFRS 13 which will be 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 – i.e. 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.

6. The Standard has not been endorsed by the European Union to date. The European Financial Reporting Advisory Group (EFRAG) draft endorsement advice and endorsement advice is still ‘to be determined’ on the final version of the Standard.

Impact on Financial Statements

Classification and Measurement

Financial Assets

7. The final 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**, thus eliminating 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.

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

9. The measurement categories for financial assets reflect the nature of their cash flows and the way they are actually managed and they are:

    - Financial assets measured at amortised cost;
    - Financial assets measured at fair value through other comprehensive income; and
    - Financial assets measured at fair value through profit or loss.

10. The measurement categories allowed for under IFRS 9 are dependent on two criteria. **Financial assets measured at amortised cost** are held in a business model whose objective is to hold assets in order to collect contractual cash flows only, in essence, a simple debt instrument.

11. In contrast, **those classified and measured at fair value though other comprehensive income** are held in a business model whose objective is achieved by both collecting contractual cash and selling financial assets. The financial asset is measured at fair value in the statement of financial position. Interest revenue, foreign exchange gains and losses and impairment gains and losses are recognised in profit or loss with all other gains or losses (i.e. the difference between those items and the total change in fair value) being recognised in other comprehensive income. This approach may result in significantly lower volatility in profits which would otherwise have arisen.

12. This classification differs from the ‘available for sale’ classification under IAS 39 as it is no longer the ‘residual category’ and *expected* losses are applied in measuring impairment. Any cumulative gain or loss recorded in other comprehensive income would be reclassified to profit or loss on derecognition, or earlier if a reclassification occurs. Interest income and impairment gains and losses would be recognised and measured in the same manner as for assets measured at amortised cost such that the amounts in other comprehensive income represent the difference between amortised cost value and fair value. This results in the same information in profit or loss, as if the asset was measured at amortised cost, yet the statement

of financial position 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.

13. **Any financial assets that are not held in one of the above two business models are measured at fair value through profit or loss**. This now represents a 'residual category'. It invokes a fair value option available on initial recognition as an alternative to measuring at fair value through other comprehensive income, particularly if it would eliminate or reduce an accounting mismatch (i.e. a measurement or recognition inconsistency). The fair value of the asset is provided both in the statement of financial position and in profit or loss. Gains or losses from interest, foreign exchange and other fair value movements are separately reported in the profit or loss and transaction costs are expensed as they are incurred.

14. The final category includes financial assets held for trading, derivatives and non-trading equity investments, which have been measured at fair value through profit or loss unless the entity elects irrevocably on initial recognition of equity to present the fair value changes (including foreign exchange gains and losses) in other comprehensive income.

15. Below is a table summarising the classification and measurement model for financial assets under IFRS 9:

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*	*Amortised cost*	*Fair value through profit or loss option ***	
YES	***Held to collect contractual cash flows AND to sell***	***Fair value through other comprehensive income ****	***Fair value through profit or loss *****	***New category introduced under IFRS 9***
YES	*All other strategies*	*Fair value through profit or loss*		
NO		Fair value through profit or loss	Fair value through other comprehensive income option for equity investments ***	

** Interest, impairment and foreign currency reognised in profit or loss, with all other gains or losses recognised in other comprehensive income. Upon derecognition amounts in other comprehensive income are reclassified to profit or loss.*

*** If at initial recognition the financial asset is irrevocably designated at fair value through profit or loss as doing so eliminates or reduces a measurement or recognition inconsistency.*

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

16. 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.

17. 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

18. IFRS 9 carried forward unchanged almost all of 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 Standard has responded to longstanding concerns about the volatility that occurs in profit or loss due to changes in an issuer's own credit risk when non-derivative financial liabilities are measured at fair value.

19. 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.

20. Fair value changes of these financial liabilities which are attributable to the change in the entity's own credit risk are presented in other comprehensive income, rather than in profit or loss, removing the counterintuitive treatment under IAS 39. Under IAS 39 (i.e. presented in profit or loss), when an entity's own credit quality deteriorates, the value of the these liabilities will reduce as a result. If the liabilities are measured at fair value then a gain is recognised in the profit or loss and vice versa. Under IFRS 9 these liabilities will continue to be measured in the statement of financial position at fair value.

21. The annex attached shows a comparison of differing accounting treatment (subsequent measurement) of financial assets and liabilities under the current IAS 39, as interpreted and adapted for the public sector, and IFRS 9.

Impairment

22. 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 single forward-looking '*expected*-loss' impairment model applied to all financial instruments**

subject to impairment accounting which will result in earlier and more timely recognition of *expected* credit losses.

23. This 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. This is likely to bring about a significant change in the subsequent measurement of financial assets.

24. 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 also 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.

25. The new model also requires that an impairment allowance, for *expected* credit losses, be 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 and in many cases provisions, debited to the profit or loss, will be recognised; leading to a 'day-one' provision.

26. 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. The exception is if the credit risk of the financial instrument is low at reporting date. IFRS 9 also includes a rebuttable presumption that credit risk has increased signficantly 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 *expected* credit losses.

27. 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 *expected* credit losses. Under the Standard an entity is to base the measurement of *expected* credit losses 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 particular measurement methods and various data sources (internal and external) may be used.

28. It should be noted that 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.

29. Both debt instruments measured at amortised cost and those measured at fair value through other comprehensive income will have the same loan loss allowance despite the different measurement methods on the statement of financial position which will result, for example, in more comparable loan loss results amongst entities with similar assets.

30. 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 sensible in that a forecast credit loss on a potential drawdown on a loan will now be measured the same way as if it is drawn down.

31. 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 *expected* credit losses and credit risk. This is a move to increase transparency on the application and to ensure users of the financial statement can make comparisons and track changes in provisions over time.

Hedge Accounting

32. IFRS 9 introduces a reformed model for hedge accounting which principally aligns the accounting treatment with risk management activities; hedging financial and non-financial exposures. This should enable entities to better reflect these activities in their financial statements and as a result significantly reduce the accounting considerations that affect risk management decisions. Consequently, the Standard also requires enhanced disclosures about risk management activity.

33. The Standard moves away from a very rules-based approach and has also increased a preparer's ability to account for hedges of non-financial items which will allow hedge accounting for some common hedging strategies that currently fail to qualify. This addresses concern over current volatility in the profit or loss from hedges, that from a risk management perspective are economically sound, and yet are currently accounted for inconsistently with the economic situation. Currently, the hedging relationships in these situations are not clearly apparent to the financial statement users and therefore the entity may appear more risky when this is not the reality, as it has hedged potential risks. Additionally, IFRS 9 requires information about all hedges to be provided in a single location in the note to the financial statements.

34. The Standard includes eligibility criteria which is based on an economic assessment, using risk management data, of the strength of hedging relationships. This should reduce the costs of implementation compared with IAS 39 and reduce the amount of analysis required for accounting purposes only.

35. Macro hedging has been treated as a separate project from IFRS 9 and is still at an early stage of development with a Discussion Paper 'Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging' having been published in April 2014. The IASB wants it to be broader than just replacing the fair value hedge accounting model for a portfolio hedge of interest rate risk in IAS 39 and is seeking to gather views from a wider range of stakeholders on how they manage risks on a dynamic basis.

Initial considerations of the impact on Central Government

36. The introduction of IFRS 9 is likely to have the greatest impact on banks and other financial instituitions. In central government, these changes are likely to have a significant impact on departments that have substantial financial assets, if introduced without adaptation. IFRS 9 has practical implications particularly for assets where no active market exists.

37. It also moves away from reliance on the terms of an instrument and looks to the entity's business model for managing financial assets to determine classification and measurement. Many central government financial assets will be held at amortised cost (such as trade receivables and simple loan investments) under IFRS 9, yet other more complex financial instruments will need to be considered carefully. The 'available for sale' and 'held to maturity' categories, which are prevalent in central government, allowed under IAS 39 do not exist in IFRS 9. In addition, IFRS 9 requires all equity investments within its scope to be recognised at fair value through profit or loss, except for those irrevocably elected through other comprehensive income. If the Treasury were to apply IFRS 9 without adaptation, and not

continue the existing adaptations included under IAS 39 in respect of special shares and public dividend capital, departments may be affected by the need to obtain fair values for interests in entities outside their boundary where there is limited or no observable market data.

38. There may be an additional front loaded burden on departments to consider the business model and cash flow characteristics when classifying and measuring financial instruments (and applying it retrospectively) when the Standard is introduced into the public sector, but the benefit is that it could also more accurately reflect the true economic situation of the assets and reduce volatility of fair value changes in the statement of comprehesive net expenditure.

39. Departments may also 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. The change in acounting treatment for financial liabilities due to own credit risk under IFRS 9 (i.e. from profit or loss to other comprehensive income) is unlikely to have a signficant impact on departments.

40. The new Standard without adaptation could also impact on the way departments account for credit losses on their loan portfolios. Provisions for bad debts will be larger with an increased likelihood of annual volatility making forecasts for AME spending/budgeting more difficult. There is unlikely to be an impact on DEL due to these fair value movements until the loss actually crystalises. The volatility in subsequent measurements of assets held at fair value through profit or loss and the new impairment model (including fluctuating impairment allowances) would present an additional challenge for the Estimates' process and presentation of departmental accounts. Departments would need to consider carefully and factor in potential adverse impacts of valuations and impairments. In addition, appropriate systems and processes for identifying where there has been a significant increase in credit risk will have to be established which could increase the burden on departments.

41. The changes to hedge accounting could also impact departments which were not able to use this before. Specifically, it seems the Standard will have a greater impact on non-financial services entities than on banks and insurers. In contrast, the macro hedging project seems to focus on financial instituitions which is still under consideration by the IASB.

Proposed text for the Government Financial Reporting Manual

42. At this stage no text is proposed for the FReM. However, interpretations and adaptations will need to be considered for the 2018/19 version.

Recommendation

43. HM Treasury ask that the Board note the finalisation of IFRS 9 and seek their early views on the potential public sector implications.

HM Treasury

20 November 2014

ANNEX

Comparison of ***subsequent measurement*** of financial assets and liabilities under IAS 39 as interpreted and adapted for the public sector (i.e. the FReM) and IFRS 9

Financial asset type	**IAS 39 Classification**	**Current public sector accounting treatment**	**Subsequent measurement under IFRS 9** ***without adaptation for the public sector***	**IFRS 9 new impairment model**
Trade and other receivables	Loans and receivables	Accounted for as 'loans and receivables' with book value used as a proxy for amortised cost.	No change provided 'business model' and 'cash flow characteristics' tests are met. Otherwise classification category is 'residual' fair value through profit or loss.	Applies to financial assets measured at amortised cost.
Student loans	Loans and receivables	Accounted for as 'loans and receivables' at amortised cost, reflecting impairments.	No change provided 'business model' and 'cash flow characteristics' tests are met. Otherwise classification category is 'residual' fair value through profit or loss.	Applies to financial assets measured at amortised cost.
Loans and deposits with banks	Loans and receivables / Held to maturity investments	Accounted for as 'loans and receivables' at amortised cost, or as 'held to maturity investments' at amortised cost. Deposits with banks are held at amortised cost, designated at fair value or 'held for trading at fair value'.	If accounted for as 'loans and receivables', no change provided 'business model' and 'cash flow characteristics' tests are met. Otherwise classification category is 'residual' fair value through profit or loss. 'Held to maturity' category not allowed under IFRS 9, thus only measured at amortised cost if 'business model' and 'cash flow characteristics' tests are met. Designated at fair value accounted for through other comprehensive income.	Applies to financial instruments subject to impairment accounting, including those classified at amortised cost and as fair value through other comprehensive income.

			'Held for trading' assets accounted for through profit or loss.	
Equity investments	Financial assets at fair value through profit or loss	Typically accounted for at fair value through profit and loss.	Accounted for at fair value with gains or losses recognised through profit or loss, unless designated at fair value through other comprehensive income in which case only dividends are recognised in profit or loss. This applies to non-trading equity investments.	Applies to financial instruments subject to impairment accounting, including those classified as fair value through other comprehensive income.
Equity investments in non-public entities where there is no observable market	Available for sale	Accounted for as 'available for sale assets'. These financial assets are carried at fair value. Gains and losses are recognised in reserves/deferred income in other comprehensive income, except for impairment losses. Impairment losses are recognised through profit or loss.	The 'available for sale' category does not exist in IFRS 9. Accounted for at fair value with gains or losses recognised through profit or loss, unless designated at fair value through other comprehensive income in which case only dividends are recognised in profit or loss. This applies to non-trading equity investments.	Applies to financial instruments subject to impairment accounting, including those classified as fair value through other comprehensive income.
Equity investments in the public sector banks	Available for sale	Accounted for as 'available for sale' assets at fair value.	The 'available for sale' category does not exist in IFRS 9. Accounted for at fair value with gains or losses recognised through profit or loss, unless designated at fair value through other comprehensive income in which case only dividends are recognised in profit or loss. This applies to non-trading equity investments.	Applies to financial instruments subject to impairment accounting, including those classified as fair value through other comprehensive income.

Debt securities	Financial assets at fair value through profit or loss	Accounted for at fair value through profit and loss as they are 'held for trading'.	Accounted for at fair value with gains or losses recognised through profit or loss. This category includes 'held for trading' assets.	
Holding of IMF Special Drawing Rights	Loans and receivables/ Financial assets at fair value through profit or loss	Accounted for as 'loans and receivables' at amortised cost At fair value through profit and loss if they are 'held for trading'.	If accounted for as 'loans and receivables', no change provided 'business model' and 'cash flow characteristics' tests are met. Otherwise classification category is 'residual' fair value through profit or loss. This category includes 'held for trading' assets.	
Derivatives	Financial assets at fair value through profit or loss	Accounted for at fair value. Derivatives that are not designated for hedge accounting are classified as 'held for trading' financial instruments with fair value gains or losses recognised through profit or loss.	Accounted for at fair value with gains or losses recognised through profit or loss. This category includes derivatives.	
Embedded derivatives		Components considered separately – i.e. embedded derivatives are separated from financial asset hosts - and accounted for at fair value	The entire hybrid instrument is assessed for classification. Unlikely to pass 'cash flow characteristics' test. Therefore, accounted for at fair value with gains or losses recognised through profit or loss.	
Lease receivables		Amounts due from the lessees are recorded in the statement of financial position as a receivable. The lease payments receivable are	No change provided 'business model' and 'cash flow characteristics' tests are met.	Applies to lease receivables within scope of IAS 17 leases.

		apportioned between repayment of the receivable and finance income. The finance income is credited through the profit or loss.	Otherwise classification category is ‘residual’ fair value through profit or loss.	

Financial liability type	**Current public sector accounting treatment**	**Subsequent measurement under IFRS 9** ***without adaptation for the public sector***
Government financing and borrowing, comprising gilts, Treasury bills and National Savings & Investment products	Accounted for at amortised cost.	Accounted for at amortised cost.
Trade and other payables	Accounted for at amortised cost.	Accounted for at amortised cost.
Deposits by banks, comprising sale and repurchase agreements	Accounted for at amortised cost, designated at fair value and 'held for trading' at fair value.	No change if accounted for at amortised cost. If designated at fair value or 'held for trading', fair value through profit or loss with fair value changes attributable to the change in entity's own credit risk presented through other comprehensive income and not profit or loss.
IMF Special Drawing Rights allocation	Accounted for at fair value.	Fair value through profit or loss with fair value changes attributable to the change in entity's own credit risk presented through other comprehensive income and not profit or loss.
Financial guarantees	Accounted for at the higher of amount initially recognised less cumulative amortisation or the best estimate of the probable expenditure required to settle financial obligations at the reporting period end.	The higher of either the amount determined in accordance with IAS 37 or the amount initially recognised (less cumulative amortisation) in accordance with IAS 18.
Derivatives	Accounted for at fair value.	Fair value through profit or loss with fair value changes attributable to the change in entity's own credit risk presented through other comprehensive income and not profit or loss.

Embedded Derivatives	Components considered separately – i.e. embedded derivatives are separated from financial liability hosts and accounted for at fair value.	Separated from host contract and accounted for as a derivative – i.e. Fair value through profit or loss with fair value changes attributable to the change in entity's own credit risk presented through other comprehensive income and not profit or loss.