HM TREASURY

Financial Reporting Advisory Board Paper

IFRS 9 *Financial Instruments* implementation: Progress update

Issue:	HM Treasury's paper of November 2015 provided the Board with a progress update against the work plan and the results of the initial public sector consultation. The Board asked for further review of two particular IFRS 9 *Financial Instruments* issues; whether hedge accounting and the simplified approach to impairment under IFRS 9 had been fully considered. This paper provides a progress update on the introduction of IFRS 9 and considers the issues raised by the Board. It also highlights some initial views on the implications of the new standard for WGA. Application of the business model test in the public sector (an issue raised at the November 2015 meeting) is presented in a separate paper.
Impact on WGA	IFRS 9 will impact WGA, specifically with regards to transition, intra-government balances and disclosures requirements.
Impact on guidance	To be considered in a later paper to the Board before issuing an Exposure Draft in 2016.
IFRS adaptation	None proposed. To be considered further in a paper to the Board before issuing an Exposure Draft in 2016.
IPSAS compliant	Prior to IFRS 9 the recognition and measurement of financial instruments were similar under IFRS and IPSAS. Changes to IPSAS in response to IFRS 9 are not yet known.
Interpretation for the public sector context?	None proposed. To be considered further in a paper to the Board before issuing an Exposure Draft in 2016.
Impact on budgetary regime and Estimates	IFRS 9 could increase volatility in the departmental AME budgets but is not likely to have a significantly different DEL impact to IAS 39.

Alignment with National Accounts	No misalignment identified at this stage. Initial discussions with the ONS indicate that IFRS 9 is broadly aligned with the National Accounts.
Timing:	No changes are expected to be made to the FReM until the 2018/19 financial year.
Recommendation:	That the Board note the progress made and seek comments and views from the Board on the issues discussed and questions raised.

DETAIL

Background

1. The International Accounting Standards Board (IASB) has issued IFRS 9 *Financial Instruments* which replaces IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 has an effective date of 1st January 2018.

2. IFRS 9 is due for implementation within the public sector in 2018-19; as agreed by the Board at the March 2015 meeting (FRAB 123) when the relevant authorities presented their high level work plan for implementation of the standard.

3. HM Treasury's paper of November 2015 (FRAB 125) provided the Board with a progress update against the work plan and the results of the initial public sector consultation. At the meeting Board members asked for further review of two particular IFRS 9 issues; specifically whether hedge accounting and the simplified approach to impairment had been fully considered by the public sector.

4. This paper provides a progress update, including the work of the technical working group's consideration of the matters raised by the Board. It also highlights some initial views on the WGA implications of the standard.

Progress update

5. In February 2016 the IFRS 9 technical working group convened and considered a variety of issues. The discussion focused on:

   a. the hedge accounting requirements of IFRS 9;

   b. the simplified approach to impairments;

   c. intra-government balances;

   d. transitional requirements;

e. disclosure requirements;

f. other implementation considerations; and

g. the impact on WGA.

6. The IFRS 9 and IFRS 15 technical working groups also held a combined meeting to discuss common implementation issues arising from the two standards. A WGA representative attended to provide early thoughts on the standards.

a. Hedge accounting

7. In November 2015 the Board queried why public sector entities would continue to follow IAS 39 hedge accounting requirements when IFRS 9 is more in line with internal management accounting. Those who responded to the consultation and apply hedge accounting indicated that they would be content to roll forward the IAS 39 requirements when IFRS 9 is introduced into the public sector.

8. At the technical working group meeting those representatives with hedging arrangements indicated the main drivers for retaining the existing treatment are:

- an overhaul of existing IAS 39 methods would be required if adopting IFRS 9 for hedge accounting; and
- in some instances it may introduce additional complexity to effectively get to the same result.

9. The technical working group agreed that the basics of hedge accounting under IFRS 9 have not changed and that the changes lie in widening the range of situations to which hedge accounting could be applied.

b. The simplified approach to impairment

10. Deloitte provided the technical working group with a high level overview of the simplified approach to impairment. 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 <u>always</u> (mandatory) recognise a loss allowance for an amount equal to lifetime expected credit losses. This applies specifically for trade receivables that do not constitute a financing transaction in accordance with IFRS 15 *Revenue from Contracts with Customers*.

For long-term trade receivables and lease receivables, an entity can <u>choose</u> an accounting policy to recognise a loss allowance at an amount equal to lifetime expected credit losses. This approach is specifically for trade receivables that constitute a financing transaction in accordance with IFRS 15.

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 does, however, result in a more sizeable loss allowance recognised on day one than may be expected for the same receivables which have been impaired under the full IFRS 9 impairment model.

c. Intra-government balances

11. The technical working group debated the value of calculating impairment allowances on intra-government balances; whether there is a risk of default or if the calculation is purely an accounting adjustment. The discussion 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 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.

12. The group also considered the complication of eliminating intra-government balances when impairment models differ between public sector bodies. However, 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.

13. It is not clear that having separate arrangements for "intra-Crown" balances would be desirable or practicable.

14. **Do the Board agree that the impairment requirements of IFRS 9 should apply to the public sector without interpretation or adaptation?**

d. Transitional requirements

15. The transitional requirements of IFRS 9 were discussed again at both the IFRS 9 meeting and the joint meeting with the IFRS 15 technical working group. It is expected, subject to the Exposure Draft processes, that both standards will be applied retrospectively without restatement. Calculation of adjustments is still necessary in order to determine the transition adjustment in the opening balances in reserves. The consensus was that a significant amount of work will be required when transitioning to the new standards.

e. Disclosure requirements

16. IFRS 9 requires modified transition disclosures instead of the restatement of comparative financial statements as this is the chosen approach to transition. IFRS 7 *Financial Instruments: Disclosures* 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.

17. 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 other comprehensive income.

18. The technical working groups agreed 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.

19. 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.

f. Other implementation considerations

20. IFRS 9 introduces the need for additional data, to support both methodology and disclosure requirements and new infrastructure for developing new processes, systems and controls, to ensure entities are able to run the existing IAS 39 and IFRS 9 models concurrently.

21. Public sector entities have a significant number of counterparties and current systems may not have the capacity to consider these individually. As a consequence, IFRS 9 is likely to have resource implications when introduced. The technical working group agreed that the standard requires a new way of looking at risk and counterparties but in some instances aggregation of counterparties to a justifiable level is allowable.

22. HM Treasury referred the technical working group to the paper[1] on transition arrangements and other implementation requirements of IFRS 9 provided to the Board in June 2015 (FRAB 124) which essentially highlights that the transition provisions of IFRS 9 are voluminous. 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.

---

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/448936/FRAB_124__05__IFRS_9_-_transition_arrangements.pdf

g. Impact on WGA

23. A representative from the WGA team provided the technical working groups with some early thoughts on the likely impacts of both standards on its consolidation process and resulting publication. From a WGA perspective consistency of disclosure requirements is desirable for both IFRS 9 and IFRS 15; one way of reporting is preferable but if this cannot be mandated then it would need to be achieved through the data collection tool.

24. WGA will need to ensure the right data is collected from public sector entities to facilitate the consolidation and this will need to be considered in advance of the data collection tool being issued. The concept of materiality from a WGA perspective will be important when assessing the impact of the standards across government and the relevant sectors.

25. From a presentational perspective, WGA will need to explain the movements to opening balances and the impacts on profit or loss (and other comprehensive income) as a result of transitioning to the new standards. Understanding the movements will be key to forming the narrative for the publication.

26. The introduction of IFRS 9 and IFRS 15 further complicates the elimination of intra-government balances. The new impairment model may affect balances and revenue and expenditure may be recognised at different points by the bodies consolidated into WGA.

Next steps

27. A further technical working group meeting will be held in the coming weeks. As it stands no compelling case for adaptations or interpretations of IFRS 9 (beyond those that apply for IAS 39) have been identified. A draft Exposure Draft will be circulated to the Board as an 'out of meeting' paper in advance of the June 2016 FRAB meeting. This will allow time for comments and views of members before a final Exposure Draft is put to the Board in June; enabling formal consultation over the summer of 2016 in line with the original timetable.

28. The communication strategy for the Exposure Draft (as recommended by the Board in November 2015) will be presented at the June 2016 meeting.

Timing

29. No changes are expected to be made to the FReM until the 2018/19 financial year.

Recommendation

30. HM Treasury ask that the Board note the progress made and seek comments and views from the Board on the issues discussed and questions raised.

HM Treasury
17th March 2016