

IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts* – HMT Exposure Drafts for Application to the Public Sector

Introduction

1. This paper provides an update on the introduction of IFRS 9 and IFRS15. HM Treasury have considered the adoption of the standards in the public sector with their Technical Working Groups. They have now prepared Exposure Drafts on each of the standards and are running a consultation over the summer, which concludes in late September.
2. DH, in conjunction with national bodies, will respond to the consultation and wishes to incorporate views from the NHS and ALBs. We also wish to take this opportunity to explore the implementation issues that will be encountered and seek views on what would be useful application guidance for the DH Group Accounting Manual.

Consultation responses

3. A brief summary of each of the new standards appears below, providing an introduction to the more detailed commentary in HMT's Exposure Drafts. Annexes 3 and 4 provide links to the Exposure Drafts, which should be read in full.
4. We would like to use this opportunity to look at the likely magnitude of the changes and seek your views on the standards and any particular areas of concern. We invite you to respond to the questions set out on each standard in the consultation response pro forma document at Annex 2.
5. We would appreciate your responses by Friday 16th September on the attached proforma by e-mail, with the subject line '**Response to IFRS 9 & 15 consultation**', to the following addresses:
 - NHS foundation trusts – FT.Accounts@monitor.gov.uk
 - NHS trusts – NHSI.TFMSqueries@nhs.net
 - CCGs/CSUs/NHS England – england.yearendaccounts@nhs.net
 - ALBs – DH_GAM@dh.gsi.gov.uk.
6. Thank you in advance for your help. We look forward to receiving your views.

Background on IFRS 9

7. IFRS 9 *Financial Instruments* will replace IAS 39 *Financial Instruments: Recognition and Measurement* and related IFRIC interpretations. The standard will be adopted from 1 January 2018, and is expected to commence in the public sector with effect from 1 April 2018.
8. The initial reason for developing a new standard on financial instruments was that users found the requirements in IAS 39 were difficult to understand and apply. The new standard was intended to take a principles based approach and to be less complex. Work on the standard was accelerated in 2009 in response to the global financial crisis, which had highlighted shortcomings in the timeliness of reporting expected credit losses under IAS 39.
9. The introduction of IFRS 9 is therefore of particular relevance to the banking sector. However, all organisations that make use of financial instruments as part of their business, including those in the public sector, will need to understand how it differs from IAS 39 and prepare for its implementation accordingly.
10. There are three main elements to the changes that IFRS 9 introduces, which are described in more detail in HMT's Exposure Draft:
 - classification and measurement of financial assets and liabilities;
 - impairment methodology;
 - hedge accounting.

Likely Implications for the NHS

Classification and measurement

11. IFRS 9 replaces the categories of financial assets defined in IAS 39 with categories based on the approach taken to measurement. These are:
 - amortised cost;
 - fair value through other comprehensive income;
 - fair value through profit or loss.
12. Allocation of financial assets to these categories is based on two tests: a 'cash flow' test, which considers whether contractual cash flows are solely payments of principal and interest (SPPI); and a 'business model' test, which considers whether the assets are held to collect contractual cash flows, a mixture of collecting contractual cash flows and selling, or any other model.
13. Simple financial assets are likely to follow a straightforward mapping with no change in measurement approach. For instance, loans and receivables under IAS 39 are held at amortised cost. Under IFRS 9, any such financial assets which are held to collect contractual cash flows and where the contractual cash flows are solely payments of principal and interest will continue to be held at amortised cost. However, it should not be assumed that entire categories under IAS 39 will map directly to IFRS 9 categories. It will be important to consider the

characteristics of all financial assets in relation to the IFRS 9 tests to determine the correct category and measurement approach. In some cases, these may differ from IAS 39.

14. Categorisation and measurement of financial liabilities is largely unchanged under IFRS 9, and DH group bodies are not expected to be significantly affected here.
15. Analysis of the DH group's Statement of Financial Position indicates that financial instruments in the NHS comprise mostly simple payables and receivables, whilst the core department and some Arm's Length Bodies hold a number of loans and equity instruments.

Impairment methodology

16. IAS 39 follows an incurred losses approach to impairment, under which impairments are only recognised where there is objective evidence that a financial asset is impaired. IFRS 9 changes this to an expected losses model, under which entities need to consider the potential for impairment over the lifetime of the asset. This should reflect the credit risk associated with the financial assets held.
17. On recognising a financial asset, it will therefore immediately be necessary to recognise a loss allowance, based on the weighted average of future credit losses with the respective risks of a default occurring being used as the weights.
18. For amounts receivable from other DH group organisations, or indeed the wider public sector, it would be expected that credit risk will be low. This should limit the extent of any loss allowances required. However, amounts receivable from other organisations may be subject to higher credit risk. NHS bodies will need to understand the methodology for calculating the loss allowances required and the information needed for this.

Hedge accounting

19. IFRS 9 introduces a less rules-based approach to hedge accounting, more closely aligned with risk management activities.
20. Currently no entities in the DH group apply hedge accounting, and the changes are not expected to have an impact.

HMT Exposure Draft Consultation

21. DH participated in HMT's technical working group on IFRS 9, contributing to the development of the Exposure Draft. Responses to HMT's consultation are due at the end of September.
22. HMT are not proposing to adapt the IFRS, other than to retain the existing interpretations of IAS 39. The proposed amendments to the FReM therefore consist largely of replacing references to IAS 39 with IFRS 9.

23. The existing IAS 39 interpretations are described in section 5 of the Exposure Draft. These state:
- financial instruments not held in furtherance of an entity's objectives but held on behalf of government more generally should be accounted for in a separate Trust Statement;
 - special or 'golden' shares should not be recognised in the Statement of Financial Position;
 - Public Dividend Capital issued is not defined as an equity instrument under IAS 32 *Financial Instruments: Presentation* and should be reported at historic cost, less impairment – relevant to core DH;
 - 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 HMT (0.7%) as applied to the flows expressed in current prices – previously adopted in the DH Manual and additionally applicable to Foundation Trusts from 2016-17.
24. The Exposure Draft is at Annex 3, and HMT's consultation poses questions seeking comments on the following:
- the new classification and measurement approach, new impairment methodology and changes to hedge accounting;
 - proposed changes to the FReM;
 - impact of forthcoming insurance contracts standard (IFRS 17) on financial guarantee contracts;
 - proposed transition approach (retrospective application without restatement);
 - proposed effective date (2018-19 financial year);
 - decision not to adapt IFRS 9 disclosure requirements;
 - retention of existing IAS 39 interpretations;
 - any other comments on the introduction of IFRS 9 in the public sector.
25. Not all of these questions will be relevant to NHS bodies, although DH would welcome any contributions to our response to HMT. Additionally, we would like to gain a view of the likely impact of IFRS 9 on the DH group and the state of preparedness of entities for its forthcoming implementation. Please therefore respond to the questions set out in the pro forma at Annex 2.

Background on IFRS 15

26. IFRS 15 *Revenue from Contracts with Customers* will replace IAS 18 *Revenue*, IAS 11 *Construction Contracts* and related IFRIC and SIC interpretations. The standard will be adopted from 1 January 2018, and is expected to commence in the public sector with effect from 1 April 2018. The standard does not apply to revenue from leases, insurance contracts, and financial instruments, where the existing standards will continue to apply.
27. IFRS 15 introduces a 5-step process for the recognition and measurement of revenue, which is more prescriptive than IAS 18:
 - Step 1: Identifying a contract with a customer
 - Step 2: Identifying performance obligations
 - Step 3: Identifying the transaction price
 - Step 4: Allocating transaction prices to performance obligations, and
 - Step 5: Satisfaction of performance obligations.
28. The core principle in IFRS 15 is that entities should recognise revenue to depict the transfer of promised goods or services to the customer at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Likely Implications for the NHS

29. IFRS 15 introduces the need for additional data, to support both methodology and disclosure requirements, and the implications for systems needs to be considered, including the ability to run the existing IAS 18/IAS 11 and IFRS 15 models over the transition period.
30. DH/NHS Improvement conducted a survey of NHS providers in October 2015, which provided useful information, which we relayed into HMT Technical Working Group's consideration. The survey indicated that overall impact in the NHS could be limited given that healthcare:
 - obligations are short term in nature;
 - transactions not that complex;
 - penalties and sanctions are low in value and rarely cross year ends; and
 - services that are bundled tend to be over the same time period.
31. IFRS 15 is more prescriptive than IAS 18 and income is either recognised at a point in time or over time. Healthcare is mostly consumed as provided so recognition over time will mostly be applicable, and the tariff system provides a clear allocation of prices to obligations. Where other income is at a point in time then it is recognised when the obligation is completed, which in some long term contracts could delay recognition.
32. Under IFRS 15 prices are to be allocated to each performance obligation, which will generally align with a spell of care under tariff. There may be some complex

spell cases with distinct elements that could involve multiple performance obligations. However the survey did indicate that some local block contracts may need further examination as there might be some obligations that need to be separately identified, being subject to different pricing under contract – particularly if they cross year ends.

33. IFRS 15 revenue is to be recorded at expected value, being what the entity is expected to be entitled to, so will incorporate penalties, deductions and discounts, etc. The survey confirmed that care that involves readmissions would probably be affected, with the income to be apportioned across the original treatment and the re-admission treatment.

IFRS 15 NHS Disclosure

34. IFRS 15 requires disclosures to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Therefore, entities are required to disclose more information about its contract with customers than currently required under IAS 11 and IAS 18.
35. Last year's survey responses reflected a number of our central concerns about disclosure. Although HMT are not proposing to adapt the standard requirements, from discussion in the Working Group they have set out key aspects for consideration on disclosure in a table in the Exposure Draft. These include:
 - referencing materiality considerations on disaggregation and contract balances;
 - stating information in segmental reporting need not be duplicated;
 - noting the exemption on performance obligations for contracts with a fixed amount per period; and
 - allowing disclosure on performance obligations can be an expansion of the accounting policy note.
36. At the heart of the disclosure issue is whether the emphasis is on a segmental breakdown of contract income and/or focus on individual material contracts. A potential disclosure note for NHS Providers is at Annex 1, building on the existing NHS foundation trust disclosure of operating income, by type of service, and applying the above points.
37. A further consideration is that it seems likely that figures will be needed at both group level and for Whole of Government Accounts, which further suggests the adoption of a segmental reporting style supplemented by narratives.
38. HMT have indicated there will be more disclosure guidance, but in the autumn.

HMT Exposure Draft Consultation

39. DH and NHS Improvement (Monitor) have participated in HMT's technical working group, which has evolved the thinking on IFRS 15's adoption in the public sector. Following these discussions, HMT are not proposing to adapt the

IFRS, although would retain the existing FReM requirements for taxes and fees, grants and donations.

40. As a result HMT are proposing relatively limited amendments to the FReM, mainly changing the reference from IAS 11 and 18 to IFRS 15.
41. The Exposure Draft is at Annex 4, in which HMT is asking six questions relating to whether:
 - there is agreement with the FReM amendments for IFRS 15;
 - entities intend to recognise assets relating to long term contracts;
 - there is agreement on transition approach;
 - there is agreement to implement in 2018-19;
 - there is agreement not to adapt the disclosure requirements;
 - there is agreement not to change the accounting for taxes, duties, fines and penalties.
42. Our views are that at this stage very strong arguments would be needed to change HMT's position on adopting the standard and where the Working Group did identify issues they tended to be sector specific. HMT were applying guidance for the whole of government and not for individual circumstances.
43. Please respond to the questions set out in the pro forma at Annex 2.

Annex 1 – Draft revenue disclosure note

		Revenue from Contracts with Customers <i>(IFRS15 113a - separate disclosure required)</i>								
		NHS Providers <i>(Disaggregation by customers - IFRS15 114)</i>								
		Total	CCGs	Local Authorities	Other Public Sector	Private Providers	Other Private Sector			
		£ 000	£ 000	£ 000	£ 000	£ 000	£ 000			
Disaggregation by type of good or service - IFRS15 114	Elective									
	Non-elective									
	Outpatients									
	A&E									
	Community services									
	Private patient activity									
	Other									
	TOTAL	-	-	-	-	-	-	-		
		To agree with the total in SOCNE								
Opening receivables		<i>(Contract balances - IFRS15 116 a)</i>								
Closing receivables.		<i>(Contract balances - IFRS15 116 a)</i>								
		<i>Where material which will need to be defined (may need to collect at least ext group bodies for group account)</i>								
Revenue expected to be recognised on contracts > 1 year in future periods.		<i>(Price allocated to remaining performance obligations - where not on a variable activity to date basis - IFRS15 120/ B16)</i>								
		<i>Where material which will need to be defined (may need to collect at least ext group bodies for group account)</i>								
Impairment losses recognised on any receivables or contract assets		<i>(Impairment losses - IFRS15 113b & 128b - write-off in year and movement on bad debt provision)</i>								
		<i>Likely to be exceptional</i>								
Ref	Narratives -	* in accounting policy								
# 119	On performance obligations* - when satisfied - ie services completed; payment terms; any sub-contract/other party arrangements, refund (readmission?) & penalty terms.									
#123	Any significant judgements in applying the standard - on timing or price allocation - with reference to the customer and type of contract									
#116 a	Any significant contract revenue recognised in reporting period included in contract liability balance (ie deferred income) at the beginning of the period to be listed with reference to the customer and type of contract.									
# 116 b	Any significant contract revenue recognised in reporting period from performance obligations satisfied in previous periods to be listed with reference to the customer and type of contract - for example if there has been a change in transaction price affecting previous years.									
# 128	Assets recognised from the costs to obtain or fulfil the contract.									

Annex 2 – Consultation response pro forma

Survey to inform implementation of IFRS 9 and IFRS 15 and to respond to HMT Exposure Drafts

Organisation :

Name :

Position :

IFRS 9 questions:

- 1) Are you aware of the replacement of IAS 39 by IFRS 9? Do you feel you have a sufficient understanding of the changes? What work, if any, have you undertaken in preparation for implementation?
- 2) Do you anticipate difficulty mapping any of your financial instruments to the new categories? If yes, what is the issue and how do you propose to resolve it?
- 3) Does your organisation have any complex or unusual financial instruments, e.g. derivatives, financial guarantee contracts? Please provide details.
- 4) Will the move to an expected losses model of impairment significantly impact your organisation? Please provide as much detail as possible, both in terms of the impact on financial statements and on accounting processes.
- 5) Are there any areas relating to IFRS 9 where you feel the DH Group Accounting Manual should provide additional guidance or set out a consistent approach?
- 6) Do you have any other comments on the Standard or the specific HMT Exposure Draft questions?

IFRS 15 questions:

- 1) Do you consider IFRS 15 (e.g. unbundling / application of expected value) will change the timing or value of your contract income recognition? Please provide brief details of the type of contract and amounts.
- 2) Do you have any long term contracts for which, under IFRS 15, you intend to recognise an asset for the costs to obtain the contract where you expect to recover those costs, or for costs to fulfil the contract that are not within the scope of another standard (e.g. IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*)?
- 3) Do you consider that there are any particular areas relating to IFRS 15 where a consistent approach should be set out in guidance or the DH Group

Accounting Manual? (For example, where there is the potential for different treatment or inconsistencies arising with the expenditure incurred by Commissioners.)

- 4) Do you consider that example disclosure is appropriate for NHS Providers' contract income? Please provide comments on its practicality and whether the information can be collected?
- 5) Do you have any other comments on the Standard or the specific HMT Exposure Draft questions?

Annex 3 – IFRS 9 Exposure Draft

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/544806/IFRS_9_ED_090816.pdf

Annex 4 – IFRS 15 Exposure Draft

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/544809/IFRS_15_ED_Final_090816.pdf