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GOVERNMENT FINANCIAL REPORTING MANUAL
(FReM) EXPOSURE DRAFT NO:

(16)01

EXPOSURE DRAFT OF PROPOSED

AMENDMENTS TO THE FReM

Application of IFRS 9 *Financial Instruments* for
the public sector

Comments to be received by 30 September 2016



HM TREASURY

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1 Introduction

1.1 The Government Financial Reporting team, HM Treasury, has published this exposure draft of proposed amendments to the Government Financial Reporting Manual (FReM) as part of its ongoing work in ensuring that the FReM reflects the latest developments in financial reporting.

1.2 The proposed amendments to the FReM are published by HM Treasury for comment only. The proposals may be modified in the light of comments received in this consultation process before being presented to the Financial Reporting Advisory Board (FRAB) for its approval. Final proposals approved by the FRAB will be published as amendments to the FReM from the proposed effective date.

Structure of exposure draft

1.3 The exposure draft provides details for each FReM chapter for which an amendment is proposed. Each section includes:

- an explanation of why the amendment is proposed
- when necessary any specific additional questions unique to that proposed amendment
- the paragraphs of the FReM chapter that are affected by the proposed amendment
- the proposed effective date of each proposed amendment

Invitation to comment

1.4 HM Treasury invites comments on the proposed amendments. It would particularly welcome responses to the questions set out in Chapter 2. Comments are most helpful if they:

- respond to the question as stated
- indicate the specific paragraph or paragraphs to which they relate
- contain a clear rationale
- describe any alternative HM Treasury should consider

1.5 Comments on this exposure draft should be submitted in writing so as to be received by **30 September 2016**. Respondents are asked to send their comments electronically to FReM.consultation@hmtreasury.gsi.gov.uk.

1.6 All responses will be published on the gov.uk website unless the respondent requests confidentiality.

1.7 HM Treasury will consider all comments received in writing by **30 September 2016**. In considering the comments, HM Treasury will base its conclusions on the merits of the arguments for and against each alternative, not on the number of responses supporting each alternative.

2 General Questions

Question 1

Do you have any comments to make on the new classification and measurement approach, the new impairment methodology and the changes to hedge accounting as a result of IFRS 9 being introduced into the public sector?

Question 2

Do you agree with the proposed amendments to the accounting for financial instruments in the FReM due to the introduction of IFRS 9 in the public sector? If so, why? If not, why not, and what alternatives do you propose?

Question 3

Will the new insurance contracts standard¹ impact how your entity accounts for financial guarantee contracts? If so, why? If not why not?

Question 4

Do you think HM Treasury should mandate the simplified approach to impairment for relevant assets (e.g. trade receivables, contract assets and lease receivables) and remove the flexibility to apply either the full or simplified model (or both) for certain assets? If so, why? If not, why not, and what alternatives do you propose?

Question 5

Do you think HM Treasury should mandate the use of IFRS 9 for hedge accounting and remove the flexibility to continue to use IAS 39 hedge accounting treatments? If so, why? If not, why not, and what alternatives do you propose?

Question 6

Do you undertake any macro hedging activities? If so, what are they and how do you currently account for them?

Question 7

Do you agree with the transition approach for the proposed amendments? If so, why? If not, why not and what alternatives do you propose?

Question 8

Do you agree with the proposed effective date for the proposed amendments? If so, why? If not, why not and what alternative do you propose?

Question 9

Do you agree with the decision not to adapt the disclosure requirements that result from IFRS 9? If so, why? If not why not and what alternatives do you propose?

Question 10

Do you agree with retaining the existing IAS 39 interpretations by making them interpretations of IFRS 9 once IFRS 9 is adopted in the public sector? If so, why? If not, why not, and what alternatives do you propose?

Question 11

¹ IFRS 17 is expected to be issued later in 2016

Are there any other comments you would like to make on the introduction of IFRS 9 into the public sector?

3 Overview of IFRS 9

3.1 Since 2005, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) had a long-term objective to improve and simplify the reporting for financial instruments. In response to the financial crisis 2007-8 the Boards decided to accelerate their plans. They decided to revise their respective accounting standards for financial instruments to address perceived weaknesses. The crisis had drawn further attention to these weaknesses.

3.2 It began as a joint project but fundamental differences in views and approaches to developing the new standard later created divergent projects. The IASB developed and issued the International Financial Reporting Standard (IFRS) 9 Financial Instruments in three phases as a compendium of improvements, which include:

- a single approach to classification and measurement
- a new forward-looking 'expected loss' impairment model
- a revised approach to hedge accounting

3.3 The new impairment model is intended to address a criticism of the impairment model used during the financial crisis, specifically, that it allowed reporting entities to delay recognition of asset impairments. The new model requires recognition of full lifetime losses more quickly.

3.4 The IASB issued the final version of IFRS 9 Financial Instruments in July 2014. This new standard replaces IAS 39 Financial Instruments: Recognition and Measurement and has an effective date of 1st January 2018.

3.5 After the IASB has published a new standard the European Union (EU) has a formal process for adoption. The European Commission (EC) requests endorsement advice¹ from the European Financial Reporting Advisory Group (EFRAG) and based on this advice the EC prepares a draft Endorsement Regulation. This Regulation is adopted only after a favourable vote of the Accounting Regulatory Committee (ARC) and favourable opinions of the European Parliament and the Council of the European Union. Following adoption, the Regulation is published in the Official Journal of the European Union, at which time it becomes effective. EFRAG have provided their endorsement advice on IFRS 9 and the ARC voted positively in June 2016. EU adoption of IFRS 9 is therefore expected in the fourth quarter of 2016.

3.6 The FReM applies EU adopted IFRS consistent with the requirements of the Government Resource Accounts Act 2000. This means HM Treasury currently expects the new standard to be applied in central government from 2018-19.

¹ <http://www.efrag.org/Endorsement>

Classification and measurement - financial assets

3.7 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. IFRS 9 replaces most of the guidance in IAS 39 and has changed the categories for classifications for financial instruments.

3.8 The measurement categories for financial assets within the scope of IFRS 9 reflect the nature of their cash flows (the contractual cash flow test) and the way they are actually managed as a group (the business model test), not how an individual asset is managed. The categories are:

- financial assets measured at amortised cost
- financial assets measured at fair value through other comprehensive income (with differences in treatment for debt and equity)
- financial assets measured at fair value through 'profit or loss'

Classification and measurement - financial liabilities

3.9 IFRS 9 carries forward unchanged almost all of the accounting requirements from 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.

Impairment methodology

3.10 IFRS 9 provides users with more useful information about an entity's expected credit losses. The entity is required to update the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments.

3.11 IFRS 9 contains a forward looking expected loss impairment model and requires the same measurement basis for impairment for all items subject to its impairment requirements such as, but not limited to: trade receivables; lease receivables within scope of IAS 17 Leases; and contract assets² within scope of IFRS 15 Revenue from contracts with customers. Furthermore, the measurement of certain loan commitments and financial guarantee contracts is based on the IFRS 9 impairment requirements rather than those of IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

3.12 The new model requires that an impairment allowance, for expected credit losses, is recognised even where no evidence of deterioration is present. When a financial asset, excluding purchased or originated credit-impaired financial assets, is first recognised a 12-month expected

² 'Contract asset' is a term introduced by the new revenue recognition standard IFRS 15 Revenue from Contracts with Customers. IFRS 15 provides a detailed definition but contract assets are generally equivalent to unbilled revenue. Even though contract assets are not financial assets, and are accounted for mainly under IFRS 15, IFRS 9's impairment requirements apply to them. This means that when entities recognise revenue in advance of being paid or record a receivable, they also need to recognise an expected credit loss.

loss allowance is also recognised – i.e. stage 1 of the model. This loss allowance is then debited to the 'profit or loss', leading to a 'day one' loss.

3.13 If a significant increase in credit risk occurs, the 12-month expected loss allowance moves to an allowance for lifetime expected losses (stage 2 of the model) thereby increasing the amount of impairment recognised. Stage 3 of the model becomes applicable when there is objective evidence of impairment, mirroring an incurred loss under IAS 39, and the financial asset has become credit impaired. If following the simplified approach (for trade receivables, contract assets and lease receivables) the impairment allowance is for lifetime expected losses.

3.14 An entity should use all reasonably available information to determine if deterioration has occurred and the 12-month/lifetime expected credit losses. Under IFRS 9 an entity should 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.

3.15 For financial assets that are considered to be credit-impaired on purchase or origination, the effective interest rate is calculated taking into account the initial lifetime expected credit losses in the estimated cash flows and there is no additional 12-month expected credit loss allowance. This treatment is consistent with the same approach under IAS 39.

The simplified approach to impairment

3.16 This approach is either required or available as a policy choice for trade receivables, contract assets and lease receivables.

3.17 For short-term trade receivables, an entity should always (mandatory) recognise a loss allowance for an amount equal to lifetime expected credit losses. This also applies to long-term receivables that do not contain a significant financing component in accordance with IFRS 15 *Revenue from Contracts with Customers*.

3.18 For other long-term trade receivables, contract assets and lease receivables, an entity can choose an accounting policy to recognise a loss allowance at an amount equal to lifetime expected credit losses.

3.19 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 may, however, result in a more sizeable loss allowance recognised on 'day one' than for the same receivables had they been impaired under the full IFRS 9 impairment model.

3.20 IFRS 9 does not prescribe how an entity should estimate lifetime expected credit losses when applying the simplified model. The Standard does however permit the use of practical expedients and the standard's application guidance refers to an example of a provision matrix³ being used to calculate the expected losses on trade receivables. It is anticipated that this approach will be widely applied in the private sector.

3.21 There is no 'one size fits all' approach to this: each entity will need to consider its own circumstances, including the materiality of expected losses and the data available (without undue cost or effort). In devising such a provision matrix, an entity is likely to use its historical credit loss experience (modified to reflect current as well as the forecast economic conditions) for trade

³ IFRS 9 Application guidance, paragraph B5.5.35

receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the relevant financial assets.

Hedge accounting

3.22 When derivatives are used as a tool for risk management, normal accounting requirements would lead to additional volatility in the 'profit or loss'. Hedge accounting is a way to reduce such volatility.

3.23 IFRS 9 introduces a revised model for hedge accounting which principally aims to align the accounting treatment with risk management activities; hedging financial and non-financial exposures.

3.24 The standard moves away from a rules-based approach and has 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. The new model also allows entities to apply hedge accounting more broadly to manage 'profit or loss' mismatches and remove what might be regarded as 'artificial' hedge ineffectiveness.

3.25 The IASB has not yet completed its project on macro hedge accounting. The Board separated this issue from general hedge accounting, creating a separate project, and designed IFRS 9 so that entities are not adversely affected whilst the project is ongoing. Entities applying fair value macro hedging will continue to use the IAS 39 fair value macro hedging model after adoption of IFRS 9. In addition, at initial application an entity may elect to continue to apply the general hedge accounting requirements of IAS 39 instead of those of IFRS 9 as an accounting policy choice. Even though this election has been provided to avoid disruption to macro cash flow hedging arrangements, it may be taken by any entity and will apply to all hedge relationships covered by the general model (i.e. all hedge relationships with the exception of macro fair value hedges).

3.26 Under both IFRS 9 and IAS 39, hedge accounting will remain optional (on a hedge by hedge basis) but under IFRS 9 there is no option to dedesignate hedge accounting – i.e. voluntary discontinuation (permitted by IAS 39) is not permitted by IFRS 9. There are extensive disclosure requirements irrespective of which model (IFRS 9 or IAS 39) is applied, however IFRS 9 has more (IFRS 7 Financial Instruments: Disclosures) on hedge accounting than IAS 39.

3.27 The IAS 39 cash flow, fair value and net investment models are retained and largely unchanged under IFRS 9. Furthermore, measuring hedge effectiveness is still required, hedge documentation is still required and hedge ineffectiveness is still to be reported in 'profit or loss'. The main differences in IFRS 9 compared to IAS 39 are a broadening of the scope of qualifying hedging instruments and qualifying hedged items and the treatment of the 'costs of hedging'.

3.28 The key benefits of adopting IFRS 9 for hedge accounting are:

- The exposures allowable to be hedged under IFRS 9 have expanded relative to those permitted under IAS 39. IFRS 9 permits risk components in both financial and non-financial items to be hedged, as long as they are both separately identifiable and reliably measurable. Therefore, price components of non-financial items can be hedged under IFRS 9. It also introduces the concept of hedging aggregated exposures – i.e. hedging exposures that consist of a derivative and an exposure. This is not currently permitted under IAS 39.

- IFRS 9 effectiveness testing requirements are less stringent (no more threshold). Retrospective testing of hedging relationships is no longer required. Prospective testing is less rigid. IFRS 9 contains new effectiveness requirements that focus on demonstrating that an economic relationship exists between the hedging instrument and the hedged exposure.
- Hedging of net position forecast transactions is not permitted under IAS 39. Cash flow hedges of net positions are available under IFRS 9 but only for hedges of foreign currency risk where the items within the net position are specified in such a way that the pattern of how they will affect the Statement of Comprehensive Income is set out as part of the initial hedge designation.
- IFRS 9 introduces a new treatment for certain 'costs of hedging' which may be excluded from the hedge designation. Under IFRS 9, for example, the change in value of the time value component of an option that has been excluded from the hedge, will initially be separately recognised in other comprehensive income and released to the profit or loss on a rational basis. Under IAS 39, if the time value component of an option was excluded from a hedge, the change in value is recognised immediately in profit or loss resulting in significant volatility.

3.29 The key benefits of continuing to apply IAS 39 are:

- It is one less change to implement, thus reducing the burden and cost of adopting IFRS 9.
- Established practices are already in place for applying hedge accounting under IAS 39. Over time, reporting entities have invested in establishing protocols that enable them to successfully administer their hedge accounting practices and have reached a point where their auditors are content with their approaches as they relate to their specific circumstances.
- The treatment of currency basis in cash flows hedges is more straight forward under IAS 39.
- The outcome from adoption of IFRS 9 is not known. Whilst the goal of IFRS 9 is to simplify hedge accounting for preparers, it introduces some new concepts that have never been applied before, and the greatest benefits are likely to be for those using more sophisticated hedging strategies.

4 Applicability of IFRS 9 for public sector reporting entities

Introduction

4.1 With £365.5 billion of other financial assets and £145.9 billion of trade and other receivables disclosed in the 2014-15 Whole of Government Accounts¹; financial instruments are material within the public sector. The Financial Reporting Advisory Board (FRAB) agreed the high level work plan for the implementation of IFRS 9 for public sector entities in March 2015². The work plan included the creation of a cross-government technical working group, the use of professional accountancy firms to provide technical expertise to the technical working groups and an initial impact assessment undertaken by the Relevant Authorities to scope the landscapes of the various sectors.

4.2 This section details the discussions of the FRAB, the technical working group and the initial impact assessment and from that, HM Treasury's proposals for the application of IFRS 9 in the public sector. HM Treasury will continue to review implementation issues in the private sector and consider any corresponding impacts in the public sector. The structure of this section is as follows:

- Classification and Measurement, including:
 - Assessing the business model in the public sector
- Impairment methodology, including:
 - The simplified approach to impairment
- Hedge accounting
- Presentation and disclosures
- Transition arrangements, including:
 - Option 1 - Retrospective application with restatement
 - Option 2 - Retrospective application but no restatement
- Implementation considerations, including:
 - Practical considerations
 - Intra-government balances
 - Timetable
- Whole of government accounts (WGA)

¹ <https://www.gov.uk/government/publications/whole-of-government-accounts-2014-to-2015>

² <https://www.gov.uk/government/publications/financial-reporting-advisory-board-minutes-and-associated-papers-17-march-2016>

Classification and measurement

4.3 Discussions on the first phase of the standard identified that the classification and measurement of financial assets is a sizeable change under the new standard. It is a different approach to what has previously been used under IAS 39 - i.e. a move away from rules-based categories to a principles-based approach to classification - however, the new impairment methodology is still the most significant change in IFRS 9.

4.4 Entities should be aware of the difference between measurement at 'fair value through other comprehensive income' for debt instruments and equity instruments and the differences to the 'available for sale' category under IAS 39. They should not start from the assumption that there will be an effortless mapping from IAS 39 but rather consider how instruments are managed and the contractual cash flows (and variations of cash flows) of the instruments.

4.5 Some financial guarantee contracts result in the transfer of significant insurance risk and thus meet the definition of an 'insurance contract' under IFRS 4 Insurance Contracts. If a department issuing financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts, and has used accounting applicable to insurance contracts, it may elect to apply either IFRS 9 or IFRS 4. This election can be made on a contract-by-contract basis and is irrevocable.

4.6 An election to account for financial guarantee contracts under IFRS 4 typically results in them being accounted for in a similar way to the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, the new insurance standard currently being developed by the IASB, with an effective date of c.2020, may have different measurement requirements. These may need to be considered when accounting for financial guarantee contracts in the future.

4.7 Where a department accounts for a financial guarantee under IFRS 9, the contract is initially recognised at fair value. Where a department is not accounting for the contract at fair value through profit or loss, the contract is subsequently measured at the higher of the loss allowance determined in accordance with the IFRS 9 impairment methodology (see below) or the amount initially recognised less the cumulative amount of income recognised in accordance with the principles of IFRS 15 *Revenue from contracts with customers*. This is a change from the requirements under IAS 39, where the subsequent measurement was the higher of the amount determined in accordance with IAS 37 or the amount initially recognised less, when appropriate, the cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

4.8 It is acknowledged that in some instances the public sector may have lending arrangements which do not meet the IFRS 9 contractual cash flow test (of solely payments of principal and interest) and/or hold financial assets where there is no active market. The IASB has issued educational guidance for non-quoted financial instruments which may be of use to the public sector. In these circumstances, HM Treasury proposes that the principles of IFRS 9 will still apply.

Assessing the business model in the public sector

4.9 HM Treasury noted that central government entities often hold financial instruments primarily for policy reasons, rather than with a business model objective in mind. The government's policy position is to ensure the effective and efficient management of publicly owned assets and keeps ownership of all assets under review. Where there is no longer a strong policy reason for continued public ownership or where there is potential for an asset to operate more sensibly and

efficiently in the private sector, the government will continue to look into the potential sale of public sector assets.

4.10 The classification approach under IFRS 9 is based on how an entity manages its financial assets. An entity's business model refers to how an entity manages its financial assets in order to generate cash flows³. The business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. The business decision for originating or acquiring financial assets in the first instance is not relevant to the ongoing management of these financial assets.

4.11 An entity's business model, for the purposes of IFRS 9, is not merely an elective choice. The business model is a matter of fact and not merely an assertion⁴. It is based on an assessment of the facts that can be observed through the activities that the entity undertakes to achieve the objective of the business model.

4.12 HM Treasury propose that the policy intention in the public sector context is not relevant to the assessment of the business model unless it directly impacts upon the management of the underlying financial assets. Therefore, the principles of IFRS 9 can be applied when assessing the business model in the public sector. No other significant issues have been raised on the classification and measurement approach.

Impairment methodology

4.13 The new impairment model has a broader scope than IAS 39, for example written loan commitments, financial guarantee contracts and contract assets are all in scope.

4.14 Under IFRS 9 there is a fundamental shift from the incurred loss model to the expected loss model and it will be important for entities to understand the concept of the 12-month expected loss allowance - i.e. that it is not the loss expected to occur in the next 12 months but it is calculated as the loss over the life of the instruments as a result of loss events in the next 12 months.

4.15 There is a significant difference in the data collected and then used in the new impairment model. For example, the new impairment model under IFRS 9 needs to incorporate forward looking data. Therefore, if assessments are based on historical default rates, then an appraisal needs to be made on how this data was collected and whether it can be applied prospectively. Historical default rates are likely to be useful as a starting point for assessing expected losses but these need to be overlaid with prospective data in order to meet the new criteria of the standard.

4.16 It was noted that entities will need to have an understanding of how the new impairment model will impact 'profit or loss' and the differences from IAS 39, for example:

- stage 3 of the IFRS 9 model is similar to the IAS 39 incurred loss model in that the trigger is consistent but the presentation of the interest income on a net basis in stage 3 is a difference compared with the gross basis of stage 2
- measurement of losses may also be different under the new model

³ IFRS 9, Appendix B application guidance, paragraph B4.1.2A

⁴ IFRS 9, Appendix B application guidance, paragraph B4.1.2B

4.17 For purchased and originated credit-impaired financial assets, a 'day one' loss is not recognised because the asset is credit-impaired at initial recognition. For these assets, the estimated cash flows used to calculate the (credit-adjusted) effective interest rate at initial recognition incorporate lifetime expected credit losses.

4.18 IFRS 9 refers to a significant increase in credit risk as part of the new impairment methodology assessment. However, the standard has been issued without prescribing this term to take into account: different levels of sophistication of entities; different data availability; and the use of judgement. The output from the *IFRS Transition Resource Group for Impairment of Financial Instruments* should be followed by entities implementing IFRS 9, particularly that relating to applying 'significant increase' in practice.

The simplified approach to impairment

4.19 £145.9 billion of trade and other receivables was disclosed in the 2014-15 Whole of Government Accounts⁵. This application of the simplified approach to impairment is likely to suit those entities that only have receivable balances. HM Treasury are considering mandating this approach for eligible assets (i.e. for trade receivables, contract assets and lease receivables) in order to reduce application issues, streamline implementation and improve comparability across the public sector. Utilising this approach would remove the need for a constant assessment for impairment but is likely to result in a significant 'day one' loss.

4.20 No other significant issues have been raised on the impairment methodology.

Hedge accounting

4.21 Hedging as a strategy is not actively encouraged in central government, in line with the principles of Managing Public Money (MPM), as government has the ability to absorb and manage these types of risks. The central government entities that responded to the initial HM Treasury impact assessment and who do apply hedge accounting indicated that they would be content to roll forward the IAS 39 hedge accounting requirements when IFRS 9 is introduced into the public sector.

4.22 The technical working group representatives with hedging arrangements indicated the main drivers for retaining the existing IAS 39 treatment for hedging relationships in the public sector are:

- an overhaul of existing IAS 39 methods would be required if adopting IFRS 9 for hedge accounting
- in some instances it may introduce additional complexity to effectively get to the same result
- the basics of hedge accounting under IFRS 9 have not changed; the changes lie in widening the range of situations to which hedge accounting could be applied

4.23 No issues have been raised on the changes to hedge accounting. HM Treasury therefore proposes that the requirements for hedge accounting under IFRS 9 should be applied in full in

⁵ <https://www.gov.uk/government/publications/whole-of-government-accounts-2014-to-2015>

the public sector. This may be reviewed in the future once the IASB has completed its project on macro hedging activities.

Question: Do you have any comments to make on the new classification and measurement approach, the new impairment methodology and the changes to hedge accounting as a result of IFRS 9 being introduced into the public sector?

Question: Do you agree with the proposed amendments to the accounting for financial instruments in the FReM due to the introduction of IFRS 9 in the public sector? If so, why? If not, why not, and what alternatives do you propose?

Question: Will the new insurance contracts standard⁶ impact how your entity accounts for financial guarantee contracts? If so, why? If not, why not?

Question: Do you think HM Treasury should mandate the simplified approach to impairment for relevant assets (e.g. trade receivables, contract assets and lease receivables) and remove the flexibility to apply either the full or simplified model (or both) for certain assets? If so, why? If not, why not, and what alternatives do you propose?

Question: Do you think HM Treasury should mandate the use of IFRS 9 for hedge accounting and remove the flexibility to continue to use the IAS 39 hedge accounting treatments? If so, why? If not, why not, and what alternatives do you propose?

Question: Do you undertake any macro hedging activities? If so, what are they and how do you currently account for them?

Transition arrangements

4.24 IFRS 9 is to be applied retrospectively, subject to some transitional reliefs in particular circumstances. The hedge accounting requirements of IFRS 9 are generally applied prospectively with some limited retrospective application.

4.25 Entities will still be required to calculate the restated amounts for the prior period comparatives regardless of which method of transition is adopted. This is because the opening balances in the current year's Statement of Financial Position will need to be restated to show the effects of adopting IFRS 9 for the first time. There are two high level options for transition to IFRS 9:

Option 1 - Retrospective application with restatement – i.e. in line with IAS 1 Presentation of Financial Statements

4.26 Prior periods may 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. It is worth noting that restatement is prohibited for comparative periods for financial instruments that have been derecognised prior to the date of initial application.

4.27 If it is impracticable for an entity to apply the effective interest rate retrospectively and the restatement approach is adopted, under IFRS 9 the entity is permitted to use the fair value of the financial asset/liability at the end of each reporting period presented as the gross carrying amount

⁶ IFRS 17 is expected to be issued later in 2016

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.

4.28 If the restatement approach is applied then IAS 1 *Presentation of Financial Statements* will 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. Furthermore restating comparatives also means providing restated information for all relevant notes.

Option 2 - Retrospective application but no restatement

4.29 If an entity elects not to restate comparative periods, quantification of adjustments is still necessary in order to determine the transition adjustments in the opening balances in reserves/other components of equity, as appropriate – i.e. not for fair value items measured at 'fair value through 'profit or loss'' or 'fair value through other comprehensive interest'. 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.

4.30 IFRS 9 requires modified transition disclosures instead of the restatement of comparative financial statements if this is the approach taken. 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.

4.31 In order to improve consistency across the public sector and to better facilitate the consolidation of public sector entities within the WGA, HM Treasury propose the following 'blanket' approach to be applied across the public sector in relation to transition: **Option 2 - Retrospective application but no restatement.**

Question: Do you agree with the transition approach for the proposed amendments? If so, why? If not why not and what alternatives do you propose?

Implementation considerations

Practical Considerations

4.32 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.

4.33 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 standard requires a new way of looking at risk and counterparties; in some instances aggregation of counterparties to a justifiable level is allowable.

4.34 In planning for the adoption of IFRS 9 it is important that preparers have a good understanding of how IFRS 9 will affect them on transition and business as usual thereafter.

Intra-government balances

4.35 The technical working group considered the value of calculating impairment allowances on intra-government balances, specifically whether there is a genuine risk of default or if the calculation is purely an accounting adjustment.

4.36 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
- providing useful disclosures to inform the user of the accounts

4.37 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.

4.38 It is not clear that having separate arrangements for "intra-Crown" balances would be desirable or practicable. HM Treasury will consider whether separate arrangements are needed if any specific instances come to light through this Exposure Draft process.

4.39 No other significant issues have been raised on the implementation considerations.

Timetable

The effective date of IFRS 9 is from 1 January 2018. HM Treasury proposes to apply IFRS 9 effective from 1 April 2018 for the public sector. HM Treasury is working to the following timetable for implementation:

Box 4.A: IFRS 15 Implementation Timetable

Summer 2016	Exposure Draft for consultation on the impact of IFRS 9
November 2016	FRAB meeting to review comments from the Exposure Draft consultation
Spring/Summer 2017	Further opportunity to consider adaptations, interpretations, or other amendments to the FReM FRAB meetings for further consideration if needed
November 2017	FRAB meeting to approve the 2018-19 FReM
December 2017	2018-19 FReM published
January 2018	IFRS 9 implementation date
2018-19	UK public sector implementation of IFRS 9

Question: Do you agree with the proposed effective date for the proposed amendments? If so, why? If not, why not and what alternatives do you propose?

Presentation and disclosures

4.40 IFRS 9 introduces new presentation requirements by amending IAS 1 to require new line items to be presented in the 'profit or loss' section of the Statement of Comprehensive Income. This includes separate presentation of interest revenue calculated using the effective interest method, gains and losses arising from the derecognition of financial assets measured at amortised cost, and impairment losses (including reversals determined in accordance with IFRS 9).

4.41 It also amends IFRS 7 *Financial Instruments: Disclosures* to introduce extensive new and amended disclosures. Some of the amendments to the IFRS 7 disclosures reflect the new classifications under IFRS 9. The changes also require an increased granularity of information presented.

4.42 There are also new disclosures to reflect substantial decisions taken by entities under IFRS 9, for example, there are new disclosures about investments in equity instruments designated as at 'fair value through other comprehensive income', new and amended disclosures on those financial instruments designated at 'fair value through 'profit or loss'' and new disclosures required when

an entity takes a decision to reclassify its financial assets following a change in its business model. There are disclosures on risk management activities (particularly as they relate to hedge accounting) and for hedge accounting, and disclosures on credit risk management and impairment.

4.43 The disclosures for the new impairment model are substantial. IFRS 7 requires that a reporting entity disclose information to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective detailed disclosures are required to provide:

- information about credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses
- information, both quantitative and qualitative, about expected credit losses including a reconciliation of changes in the amount of expected credit losses and the rationale for those changes
- information about an entity's credit risk exposure (including where there is significant credit risk abundance or concentrations)

4.44 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'.

4.45 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. 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.

4.46 HM Treasury considers it appropriate to retain the disclosure requirements in full but to emphasise the materiality considerations that entities are expected to undertake in determining whether they are required to provide particular disclosures.

4.47 HM Treasury will engage with preparers and issue additional application guidance to improve understanding of the disclosure requirements well in advance of the effective date to support implementation of the standard in the public sector.

Question: Do you agree with the decision not to adapt the disclosure requirements that result from IFRS 9? If so, why? If not why not and what alternatives do you propose?

Whole of government accounts (WGA)

4.48 The introduction of IFRS 9 is likely to complicate further the elimination of intra-government balances. The new impairment model may affect balances and different recognition points by the bodies consolidated into WGA.

4.49 Consistency of reporting methodology and disclosure requirements is preferable from a WGA perspective. However, it is recognised that given the individual nature of each public sector body, it is unlikely to be appropriate to mandate the same disclosures in every account, especially where it would not be material for the organisation.

4.50 WGA will need to ensure the right data is collected from public sector entities to facilitate the WGA consolidation process. This process and the requirements from entities 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 Standard across government and the relevant sectors.

4.51 From a presentational perspective, WGA will need to explain the movements to opening balances and the impacts on the Statement of Comprehensive Net Expenditure/Income and the Statement of Financial Position as a result of transitioning to IFRS 9. Understanding the movements will be key to forming the narrative for the publication.

4.52 The WGA team will need to consider these challenges as they develop their implementation plan for IFRS 9. Subject to responses from this consultation, HM Treasury proposes that IFRS 9 will be applied in full to WGA.

Existing FReM

5 interpretations of IAS 39

5.1 *Any financial instrument that is not held in furtherance of the department'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.*

5.2 *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.*

5.3 *PDC should be reported at historical cost, less any impairment.*

5.4 The FReM contains an interpretation that states that PDC is not defined as an equity instrument under IAS 32 Financial Instruments: Presentation (as it does not meet the definition of a financial instrument under IAS 32) and should be reported at historic cost, less impairment. IFRS 9 does not change the definition of a financial instrument, and PDC is therefore outside of its scope.

5.5 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 (0.7%) as applied to the flows expressed in current prices.

Question: Do you agree with retaining the existing IAS 39 interpretations and rolling them forward to apply once IFRS 9 is adopted in the public sector? If so, why? If not, why not, and what alternatives do you propose?

6)

Proposed amendments to the Government Financial Reporting Manual

Introduction

An amendment to each of the following chapters is proposed:

- Chapter 4, Accounting boundaries
- Chapter 6, Applicability of Accounting Standards
- Chapter 7, Further guidance on accounting for assets and liabilities Property, plant and equipment (PPE)
- Chapter 8, Income and Expenditure
- Chapter 10, Whole of Government Accounts

Why the amendments are proposed

The amendments proposed in this exposure draft seek to amend the FReM to incorporate IFRS 9 where it is appropriate.

Effective date of amendments

The effective date for the proposed amendments is 1 April 2018, specifically the 2018-19 FReM.

Proposed amendments

FReM amendments are proposed to reflect IFRS 9 being adopted for the first time in the public sector.

4 Accounting boundaries

4.1 Accounting boundaries

- 4.1.3 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~~ IFRS 9. This includes all interests in bodies classified as public corporations by the ONS and investments in public sector bodies which would otherwise meet the definition of an associate or joint venture.

6 Applicability of accounting standards

6.1 EU adopted IFRS

- 6.1.1 A list of EU adopted IFRS is shown in Table 6.1, together with a record of whether they have been adapted or interpreted for the public sector context in this Manual. All standards apply to all reportable activities and reporting entities applying this Manual to the extent that each standard is relevant to those activities and in the light of any statutory requirements or other pronouncements that might from time to time be made by the relevant authorities. Where adaptations or interpretations are different for ALBs this is identified below.

Table 6.1

International Standard	Applies without adaptation	Applies as interpreted for public sector	Applies as adapted for public sector	Different adaptations or interpretation for ALBs
IAS 39 Financial Instruments: Recognition and Measurement IFRS 9 Financial Instruments		•		

6.2 Interpretations and adaptations for the public sector context

6.2.1 Table 6.2 provides details of those adaptations and interpretations for the public sector context. Where an adaptation or interpretation to a Standard results in an inconsistency with a related Interpretation issued by the IFRS Interpretations Committee (IFRIC) or Standards Interpretations Committee (SIC), that Interpretation is similarly adapted or interpreted. In all other case, IFRIC and SIC Interpretations will apply in full.

6.2.2 Chapter 10 of this Manual provides additional guidance on adaptations and interpretations for the Whole of Government Accounts

Table 6.2

IFRS 9 Financial Instruments	
Interpretations	(1) 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. (2) Special or 'golden' shares, being those shares retained in businesses that have been privatised but in which the department wishes to retain a regulatory

	<p>interest or reserve power, should not be recognised in the Statement of Financial Position.</p> <p>(3) PDC should be reported at historical cost, less any impairment.</p> <p>(4) 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 (promulgated in PES papers) as applied to the flows expressed in current prices.</p>
IFRS 11 Joint Arrangements	
Adaptations	<p>In accordance with the principles set out in Managing Public Money, executive non-departmental and similar public bodies classified to central government by the ONS will normally be controlled for accountability purposes by only one department in accordance with IFRS 10, and not as a joint arrangement under IFRS 11.</p> <p>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 IFRS 9. This includes all interests in bodies classified as public corporations by the ONS, which are within the scope of Managing Public Money principles.</p> <p>Agencies should follow the requirements of IFRS 11 with respect to public sector entities only if the entities are within the controlling department's consolidation boundary.</p> <p>Departments and agencies should apply IFRS 11 without adaptation to bodies classified to the private sector and rest of the world by the ONS.</p> <p>ALBs should apply IFRS 11 without adaptation.</p> <p>Chapter 4 provides guidance on the departmental accounting boundary and application of consolidation standards.</p>
IAS 28 Investments in Associates	
Adaptations	<p>In accordance with the principles set out in Managing Public Money, executive non-departmental and similar public bodies classified to central government by the ONS will normally be controlled for accountability purposes by only one department. Therefore the public sector entity will be included in one department's consolidation order and will be consolidated by that department in accordance with IFRS 10.</p> <p>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 IFRS 9. This includes all interests in bodies classified as public corporations by the ONS, which are within the scope of Managing Public Money principles.</p> <p>Agencies should follow the requirements of IAS 28 with respect to public sector entities only if the entities are within the controlling department's consolidation boundary.</p> <p>Departments and agencies should apply IAS 28 without adaptation to bodies classified to the private sector and rest of the world by the ONS.</p> <p>NDPBs and trading funds should apply IAS 28 without adaptation.</p>
IAS 39 Financial Instruments: Recognition and Measurement	
Interpretations	<p>(1) 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.</p> <p>(2) 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.</p> <p>(3) PDC should be reported at historical cost, less any impairment.</p> <p>(4) 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 (promulgated in PES papers) as applied to the flows expressed in current prices.</p>

7 Further guidance on accounting for assets and liabilities

7.1 *Property, plant and equipment (PPE)*

Accounting for PPP arrangements, including PFI contracts, under IFRS

7.1.62 The grantor should recognise any guarantees to the operator that it will meet any shortfalls in revenue or repay the debt if the operator defaults in line with the requirements of IAS 32 and ~~IAS 39~~ IFRS 9.

8 Further guidance on accounting for income and expenditure

8.2 *Consolidated Fund revenue*

Trust Statements

8.2.15 Trust Statements shall also include the following expenditure:

- a) the costs of collection and administration where there is express statutory provision for those costs to be deducted from the revenue collected;
- b) the costs of compensating (limited to repayments and interest) those from whom taxes or penalties have been incorrectly collected. Other elements of compensation and related costs shall be accounted for in departmental accounts; and
- c) any allowance for uncollectible amounts measured in accordance with ~~IAS 39~~ IFRS 9.

10 Whole of Government Accounts

10.2 *Accounting standards applied to Whole of Government Accounts*

10.2.1 This section summarises the applicability of accounting standards to WGA. Changes to adaptations and interpretations of standards from those detailed in Chapter 6 that apply to WGA are explained in the paragraphs below.

~~IAS 39 IFRS 9 Financial instruments – recognition and measurement~~

10.2.2 ~~IAS 39 IFRS 9~~ is interpreted for WGA in the same way that is interpreted for the financial statements of reporting entities covered by this Manual, with the exception that all public sector financial instruments shall be consolidated into WGA and shall not be included in a separate Trust Statement.