HM Treasury

Financial Reporting Advisory Board Paper

IFRS 9 adaption review and potential expansion

Issue:	HM Treasury updates FRAB on the impacts of the adaptation made to IFRS 9, introduced in the 2021-22 FReM, and on HM Treasury's plans to explore the expansion of the adaptation beyond financial guarantees.
Impact on guidance:	No changes currently proposed.
IAS/IFRS adaptation or interpretations for the public-sector context?	N/A
Impact on WGA?	N/A
IPSAS compliant?	N/A
Impact on Estimates/budgetary regime?	N/A
Alignment with National Accounts	N/A.
Recommendation:	**The Board notes the preliminary findings around the implementation of the new IFRS 9 adaptation and provides any comment on HM Treasury's continued consultations and investigation on the need and value of expanding the IFRS 9 adaptation beyond financial guarantee contracts.**
Timing:	N/A

DETAIL

Background

1. HM Treasury proposed, at the June 2021 board meeting (FRAB 144), an additional adaptation to IFRS 9 *Financial Instruments* to apply solely to financial guarantees. The proposals was discussed further at the November 2021 meeting (FRAB 145) where the Board agreed its publication in the 2021-22 FReM.

2. The adaptation sought to address two issues:

- The first is to prescribe the measurement basis (expected credit losses) for certain policy driven financial guarantees, where otherwise applying fair value measurement would present significant scope for inconsistent treatment.

- The second is to override the need to defer the difference between fair value and the transaction price, which in the case of policy driven guarantees charged at significantly below fair value, the deferral results in understating the liability position of the entity.

3. The adaptation, as it appeared in the 2021-22 FReM:

IFRS 9 *Financial Instruments*	
Adaptations	Where an entity issues a financial guarantee below fair value and where no active market or observable equivalent exists such that it would follow B5.1.2A section (b), then it should instead measure the financial guarantees at initial recognition, and at reporting period end, at an amount equal to lifetime expected credit loss (ECL) in accordance with the requirements of IFRS 9. Initial measurement and subsequent measurement are to be recognised through profit and loss. For the purpose of applying Interpretation (4)[1] of the FReM's interpretation of IFRS 9, and for the purpose of determining suitable disclosures under IFRS 7, the department shall apply them as if ECL were Fair Value. In the case of Interpretation (4), if it can be evidenced that the intrinsic rate cannot be reliably determined, then the HM Treasury Financial Instrument rate should be used.

4. The adaptation was written to be as sympathetic to the existing Standard as possible. To achieve its objective, it departed from the letter of the Standard but not the spirit. The purpose of mandating the use of Lifetime ECL for initial and subsequent measurement achieved these goals and knits the adaptation's change and knock-on effects back into the normal application of IFRS 9, with minimal deviation.

5. By overriding section B5.1.2A's requirement to defer recognition, the adaptation removed an individual preparer's judgment for determining a change in factor and ensured all financial guarantees in these circumstances are brought fully on balance sheet, at recognition, in a consistent way across central government, increasing transparency and comparability for the users of the accounts.

Adaptation application

6. HM Treasury has used its normal pattern of engagement with departments and the National Audit Office (NAO) as they prepare and audit 2021-22 accounts to understand any practicalities of applying the adaptation including, for example, direct requests of assistance/clarification on the correct application of the new adaption.

7. HM Treasury is closely monitoring the impact of the adaptation and has had targeted discussions with departments, such as BEIS and HMT itself, that have significant financial guarantees. The new adaptation has been raised with cross government working groups such as the Resource Accounts Special Interest Group (RASIG) and the Technical Accounting Centre Of Excellence (TACOE) to gain a wider understanding of views on applicability and challenges. Opinions were positive and the adaptation has thus far not trigger

unexpected results in departmental accounts at year end for 2021-22. The most significant inquiry was from the Foreign, Commonwealth & Development Office (FCDO) that clarification about whether the change should only be applied prospectively and whether could apply to sovereign counterparties. HM Treasury clarified that it should be treated as a change in accounting policy, and there is no in principle reason why it should not apply to sovereign counterparties.

Moving forward

8. The current adaptation is focussed on financial guarantees only. With the 2021-22 Annual Reports and Accounts in the process of being completed and undergoing audit, the current indication is the adaptation is applying as intended, though this cannot be confirmed until the audit cycle is complete. HM Treasury is now exploring the wider, longer-term piece of work, building on comments from the Board from the November 2021 (FRAB 145), of the need and value to expand the adaptation to encompass a wider range of financial instruments in the scope of IFRS 9. Specific Board comments focussed on supporting guidance for preparers, government grants where there was nil consideration, whether other manuals beyond the FReM would require updating and any transitional issues such an adaptation to wider financial assets and liabilities may cause.

9. Work has begun with departmental preparers and the NAO to gather an understanding of the practical experiences they have had with other financial instruments (both assets and liabilities), the methodologies they use to account for them and their understanding and application of IFRS 9. Direct discussion with those central departments potentially significantly affected, (BEIS, DfE, DHSC & HMT itself), has begun as well as with the NAO to take a broader view of the ARA landscape. The issue has been presented at cross government working groups, such as RASIG and TACOE, and via the Government One Finance platform to gain further insight.

10. The emerging picture is that preparers attempt to recognise financial instruments as faithfully and transparently as possible in accordance with the FReM. Initial discussions however suggest variation in the approaches. For example; where the Standard requires a deferral of recognition until a factor, including time, has changed; one department, for a specific asset, assumes day 2 to be a change and remeasures. However, for another asset they consider the end of the first reporting period to cause a change. In both examples the preparers are attempting to recognise the liabilities faithfully though the differing results may affect perceptions of consistency for users of accounts.

11. HM Treasury is working with the Department for Business, Energy & Industrial Strategy (BEIS) and the Low Carbon Contracts Company (LCCC) to better understand Contracts for Difference and the treatment applied in this case.

12. The Contracts for Difference (CfD) scheme is a government mechanism for supporting low-carbon electricity generation. It is designed to incentivise investment in renewable energy by providing protection from volatile wholesale prices, guaranteeing a flat (indexed) rate for the electricity they produce by paying the difference between an agreed strike price and a reference price. These contracts give rise to a material difference between the transaction

price (nil consideration) and fair value, with the difference deferred and not recognised as an asset (or liability) on BEIS' (or LCCC's) balance sheet (but there are extensive disclosures). Work has begun between BEIS and HM Treasury to fully consider the impact on CfDs from any future adaptation to IFRS 9.

13. Experience from 2021-22 suggests that thus far the adaptation is operating as intended. At present there is no clear emerging case for widening the scope of the adaptation to all financial instruments, but HM Treasury will return to the Board with a firmer conclusion on the need or otherwise for further expansion once its consultations and investigations have concluded and we will return to the Board on this issue in November.

Recommendation

14. The Board notes the preliminary findings around the implementation of the new IFRS 9 adaptation and provides any comment on HM Treasury's continued consultations and investigation on the need and value of expanding the IFRS 9 adaptation beyond financial guarantee contracts.

HM Treasury
30th June 2022