HM Treasury

Financial Reporting Advisory Board Paper

IFRS 9 update

Issue:	HM Treasury updates FRAB on HM Treasury's analysis of the potential expansion of the IFRS 9 adaptation beyond financial guarantees.
Impact on guidance:	N/A at this stage.
IAS/IFRS adaptation?	No adaptations or interpretations proposed at this stage.
Impact on WGA?	None.
IPSAS compliant?	N/A
Interpretation for the public-sector context?	No adaptations or interpretations proposed at this stage.
Impact on budgetary regime and Estimates?	N/A
Recommendation:	**The Board notes the findings around the expansion of the existing IFRS 9 adaptation and provides any comment on HM Treasury's findings.**
Timing:	N/A

DETAIL

1. HM Treasury have explored the value in expanding the IFRS 9 adaptation in the FReM, that was initially focused on the treatment of financial guarantee contracts, to a wider range of financial instruments.

2. The emerging position is that the treatment of differences between transaction price and fair value across central government is broadly uniform and largely consistent with the proposed adaptation expansion. The only exception currently identified is BEIS' Contracts for Difference scheme, which does have material deferred differences that are not recognised on the balance sheet at 31st March 2022.

3. As consultations are still ongoing, HM Treasury are asking the Board to note the progress made and expect to propose a final recommendation to the Board by March 2023.

Background

Original Adaptation

4. 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 were discussed further at the November 2021 meeting (FRAB 145) where the Board agreed to the publication of the adaptation in the 2021-22 FReM.

5. At the June 2022 board meeting (FRAB 147), the Board expressed support for continued consultations and investigation on the need and value of expanding the IFRS 9 adaptation beyond financial guarantee contracts, to all financial instruments. HMT has worked with departments to determine whether and how to expand the IFRS 9 adaptation to all financial instruments.

6. The adaptation incorporated into the 2021-22 FReM 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 (FRAB 147 (16))

     The second is to override the requirement in IFRS 9 to defer the difference between initial measurement of the guarantee and the transaction price, where in the case of policy driven guarantees charged at significantly below fair value, the deferral results in understating the liability position of the entity.

7. 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) 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.

8. IFRS 9 B5.1.2A is shown in Appendix A.

9. This adaptation is focussed on financial guarantees only. With the 2021-22 Annual Reports and Accounts mostly complete, the current indication is the adaptation has not triggered any unexpected results in departmental accounting.

Adaptation expansion preliminary findings

10. HM Treasury have continued to explore the wider, longer-term piece of work as discussed in June 2022 (FRAB 147), building on comments from the Board from the November 2021 meeting (FRAB 145). It explored the need and value to expand the adaptation to encompass a wider range of financial instruments in the scope of IFRS 9.

11. BEIS was identified as the main department that would be impacted by this proposed scope widening of the adaptation, specifically their Low Carbon Contracts Company's (LCCC) Contracts for Difference (CfD) (discussed in more detail below).

Findings

12. IFRS 9, B5.1.2A section (b) was designed to stop private sector IFRS users, such as banks or financial institutions, from recognising large day one gains on financial instruments in an active market. It does not contemplate the issuance of financial instruments by government at a loss in pursuit of economic policy, at nil or nominal transaction value.

13. Based on the information received in consultations, our preliminary view is that widening the adaptation to all financial instruments will improve both transparency and comparability:

    a. As IFRS 9 B5.1.2A section (b) allows entities to defer the recognition of fair value until beyond the end of the reporting period, this allows departments to hold some of the value of their financial instruments off balance sheet (and therefore out of the scope of budgets and Estimates).

    b. As IFRS 9 B5.1.2A section (b) allows entities to make timing-based decisions driven by considerations that would be taken by market participants when pricing the asset or liability. Government activity often takes place under conditions where market participants would not be interested in the purchase or transfer of the assets or liabilities in question. This leaves timing decisions open to high levels of subjectivity, such that they can materially vary from department to department, reducing comparability.

14. In line with the reasoning presented in FRAB 144 (05) which proposed the initial IFRS 9 adaptation, it is HM Treasury's view that preventing central government departments from recognising losses (at initial recognition) when issuing financial instruments where no active market exists is an unintended consequence of IFRS 9, B5.1.2A section (b).

15. Multiple consultations were conducted with DfE, BEIS, FCDO, MoD, DHSC and HMT Finance teams on the application of the IFRS 9 adaptation and its expansion. These

departments were consulted as they could be significantly affected by an adaptation expansion.

16. Most consultations conducted indicate that there are no material causes for concern in expanding the adaptation of IFRS 9 because the majority of departments recognise all differences between transaction price and fair value of financial instruments as a gain or loss by 31st March in the year in which they enter into the transaction when applying IFRS 9 B5.1.2A section (b).

17. This treatment leads to the same year end position in Annual Reports and Accounts that would be produced from an expansion of the existing IFRS 9 adaptation. The exception is Contracts for Difference (CfD) held by BEIS, which is discussed below in more detail.

18. Continued consultations with BEIS highlighted two areas that creates material cause for concern.

Contracts for Difference

19. 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 electricity producers a flat (indexed) rate for the electricity they produce by paying the difference between an agreed strike price and a reference price.

20. These contracts give rise to a material difference between the transaction price (nil consideration) and fair value, with the difference between transaction price and fair value disclosed, but not recognised as an asset (or liability) on BEIS' (or LCCC's) balance sheet until the relevant payment period for the CfD commences.

21. Expanding the IFRS 9 adaptation to cover all financial instruments, including CfDs, would therefore potentially have a material impact for BEIS' annual report and accounts. At 31st March 2022, the CfD fair value was disclosed in BEIS' Annual Report and Accounts as £98bn, with £71bn of that fair value being deferred differences held off balance sheet.

22. Deferred differences are recognised when the payment window, or right to potential CfD payments, begins. The recognition of deferred differences is amortised over the life of a CfD which is typically 15 years, although some contracts that are bespoke and relate to Hinkley Point C have a life of 35 years.

23. This raises questions about the consistency and comparability of the treatment of financial instruments with differences between transaction price and fair value across central government. One could also argue that applying the proposed IFRS 9 adaptation to CfD contracts would result in better-quality and more transparent information about CfDs that aids accountability.

24. BEIS are working with NAO to understand the impact of a potential adaptation expansion, that would result in bringing the deferred difference of CfDs on balance sheet. There are concerns about the auditability of the deferred differences, currently

valued at £71bn, due to the high degree of estimation uncertainty inherent in forecasting electricity generation volumes and wholesale electricity prices that inform CfD instrument values. We are expecting to be in an informed position within the next few months.

Future energy interventions

25. Volatility in the energy market continues and some current interventions, such as the Energy Price Guarantee and the Energy Bill Relief Scheme are due to end in March 2023. There is uncertainty over future energy-related interventions HM Government might make and how they might be impacted by an adaptation expansion. HM Treasury continue to work with BEIS and expect to be in a more informed position within the next few months.

Recommendation

26. ***The Board notes the findings around the expansion of the existing IFRS 9 adaptation and provides any comment on those findings.***

HM Treasury
24th November 2022

Appendix A

IFRS 9. B5.1.2A:

The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also IFRS 13). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:

(a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

(b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.