Financial Reporting Advisory Board Paper

IFRS 9 FReM adaptation for financial instruments

Issue:	HM Treasury requests that FRAB agrees to a proposed adaptation of IFRS 9 for the 2023-24 FReM.
Impact on guidance:	The 2023-24 FReM will be updated to include the adaptation.
IAS/IFRS adaptation or interpretations for the public-sector context?	Yes – the 2023-24 FReM will introduce a new adaptation for the public-sector context for IFRS 9.
Impact on WGA?	Changes will be made in departmental accounts and consolidated into WGA from 2023-24.
IPSAS compliant?	FReM specific adaptation. More closely aligned to IPSAS 41, the IFRS 9 requirement for deferred differences differs from IPSAS 41.
Impact on Estimates/budgetary regime?	Accounting changes may have a knock-on effect on budgets for financial instrument values that are brought on balance sheet as a result of its implementation.
Alignment with National Accounts	Yes.
Recommendation:	**The Board agrees to publishing the proposed adaptation to IFRS 9 in the 2023-24 FReM.**
Timing:	The updated Manuals will be published in November 2023 for 2023/24 implementation.

Overview

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 all financial instruments in the scope of IFRS 9.

2. Consultations have now completed and HM Treasury are recommending an additional IFRS 9 adaptation to the Board to better support transparency and accountability within central government financial reporting.

Background

3. Details of the original IFRS 9 adaptation published in the 21-22 FReM, relating to financial guarantees, can be found in Appendix A.

4. HM Treasury explored if the IFRS 9 adaptation needed expanding, as discussed in June 2022 (FRAB 147), building on comments from the Board from November 2021 (FRAB 145), about the need and value to expand the adaptation to encompass a wider range of financial instruments in the scope of IFRS 9.

5. As discussed in November 2022 (FRAB 148), the majority of outreach indicated that there are no material causes for concern in the application of an expansion of the existing IFRS 9 adaptation, with the exception of Contracts for Difference (CfD) held by BEIS.

6. 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 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.

7. 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 or receiving 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 of the financial instrument, with the difference deferred and not recognised as an asset (or liability) on BEIS' (or LCCC's) balance sheet (however, there are extensive disclosures).

Findings and Rationale for Recommendation

8. CfDs have been identified as the main area which could see material impact if the scope of the IFRS 9 amendment is expanded to all financial instruments.

9. As at 31/3/22, CfDs recognised on-balance sheet were valued at £26.9bn. The difference between transaction value and fair value that is deferred and held off balance sheet, as IFRS 9 allows, is £70.7bn.

10. This raises questions about whether the current treatment of CfDs is appropriate; expanding the IFRS 9 adaptation to cover financial instruments like CfDs would very likely increase transparency and accountability around these financial instruments by valuing them more accurately on the balance sheet. HM Treasury have not been able to identify any conceptual reasons as to why the difference between transaction value and fair value for CfDs should be deferred and held off-balance sheet.

11. BEIS have considered the impact of an adaptation expansion on their full portfolio of financial instruments and have argued that adopting this adaptation for CfDs will present two challenges for them.
    a. Firstly, it will present a divergence from LCCC's own accounting under Companies Act 2006. This divergence in accounting will create consolidation challenges and may create a reputational risk (especially considering the size of the divergence at £70.7bn).
    b. Secondly, it will bring the more volatile part of the CfD portfolio into the scope of budgets and Supply Estimates (as valuation changes for CfDs will have budget/Estimate impacts).

12. The HM Treasury view is that neither of these challenges should drive the Board's decision-making on this issue (as there are other differences between FReM and Companies Act requirements, and budget/Estimate impacts should not drive FReM requirements).

13. BEIS have not highlighted any technical or conceptual concerns with the proposed adaptation expansion.

14. As per the reasoning presented in FRAB 144 (05) which proposed the initial IFRS 9 adaptation, IFRS 9, B5.1.2A section (b) prevents users of IFRS, such as some financial institutions/banks, from recognising large day one gains on financial instruments. Some central government entities may issue financial instruments where no active market exists and at nominal or nil transaction value. In this instance, they are prevented form recognising day one losses when applying the Standard as written.

15. 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) and therefore proposes the following adaption be amended to expand the scope of its application in the 2023-24 FReM and onwards.

16. As per the reasoning presented in FRAB 148 (12) which detailed on going findings, it is HM Treasury's view that widening the scope of the adaptation to all financial instruments will improve both transparency and comparability of departmental Annual Reports and Accounts.

17. The adaptation will improve transparency by ensuring the recognition of the difference between transaction value and fair value is brought on balance sheet and therefore within the scope of budgets and Estimates.

18. The adaptation will improve comparability by ensuring the difference between transaction value and fair value is uniform across central government.

Proposed Adaptation

IFRS 9 *Financial Instruments*	
Adaptation	Where an entity issues a financial instrument, other than 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 the entity should instead measure the instrument at initial recognition at fair value.

19. IFRS 9 B5.1.2A section (b) is replicated in Appendix B.

20. HM Treasury is proposing a new adaptation that covers all financial instruments except financial guarantees and leaves the original adaptation specifically for financial guarantees in place. This is opposed to an approach which amends the original financial guarantee adaptation to expand its scope to all financial instruments.

21. The reason for this approach is because our outreach activity highlighted that prescribing the lifetime expected credit loss valuation method, as the original financial guarantee adaptation did, for the full range of financial instruments in scope of IFRS 9 may have unintended consequences. This is because, for some market-driven financial instruments, credit loss[1] is not the primary driver of future cash flows.

22. For example, if CfDs were to be valued at lifetime ECL as opposed to the income approach (currently used per IFRS 13), this would not result in the most accurate valuation because CfDs are instruments whose future cash flows are dictated by changes in energy market conditions, as opposed to changes in the counterparty's ability to meet its contractual obligations (the counterparty should always be able to meet its contractual obligations because their obligations to pay LCC can be funded from their sales of energy).

23. HM Treasury's view is that, except for financial guarantees, the choice in valuation method for financial instruments that are classified as 'fair value through other comprehensive income' or 'fair value through profit and loss', should be left to the judgement of the Accounting Officer and their finance team interpreting IFRS 13. This is consistent with IFRS 9, which does not prescribe a valuation method for the fair value of financial instruments.

[1] IFRS 9 definition: "The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls) , discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)."

Adaptation Expansion Application

24. HM Treasury propose that this adaptation is applied retrospectively, in line with treatment of accounting policy changes under IAS 8, as laid out in Appendix C.

Recommendation

The Board supports introducing a new adaptation to IFRS 9 to measure financial instruments, with the exception of financial guarantees, at initial recognition at fair value.

HM Treasury
30th March 2023

Appendix A

IFRS 9 Financial Guarantee adaptation history

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 its publication in the 2021-22 FReM.

HM Treasury proposed continued consultations and investigation on the need and value of expanding the IFRS 9 adaptation beyond financial guarantee contracts at the June 2022 meeting (FRAB 147) to which the Board agreed.

The adaptation incorporated into the 2021-22 FReM sought to address two issues:

a. 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))
b. 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.

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.

This adaptation is focussed on financial guarantees only. With the 2021-22 Annual Reports and Accounts now complete, the indication is the adaptation is applying as intended.

Appendix B

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.

Appendix C

IAS 8.5 “Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.”

IAS 8.5 “*Retrospective application* is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.”

IAS 8.14

“An entity shall change an accounting policy only if the change:

(a) is required by an IFRS; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity’s financial position, financial performance or cash flows.”