CIPFA The Chartered Institute of Public Finance & Accountancy

report

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Committee	CIPFA/LASAAC
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Subject	Development of the 2017/18 Code of Practice on Local Authority Accounting – IFRS 9 *Financial Instruments*

To consider the approach to adoption of IFRS 9 in the Code of Practice on Local Authority Accounting in the United Kingdom

1 Introduction

1.1 This report outlines the issues that CIPFA/LASAAC will need to consider for the adoption of IFRS 9 *Financial Instruments* in the *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code). It sets out the main requirements of the Standard in overview and seeks CIPFA/LASAAC's views on the approach to adoption in the Code.

2 Background – Developments to Date

2.1 The IASB has developed IFRS 9 in phases. It was first issued in 2009 with a new classification and measurement model for financial assets followed by additions in 2010 relating to requirements for financial liabilities and derecognition. In 2013, the Standard was amended to include a new hedge accounting model. It was finalised in July 2014 with the final version of the Standard, superseding all previous versions. The new Standard has an effective date of 1 January 2018 so it will formally apply to the 2018/19 Code, subject to the Board's decisions on adoption.

2.2 IFRS 9 includes:

- a single classification approach for financial assets driven by cash flow characteristics and how the instrument is managed
- a forward looking "expected" loss model for impairment rather than the "incurred" loss model under IAS 39, and.
- new provisions on Hedge Accounting.

2.3 As set out in the report 08 03-16, the Secretariat recommends that details of the 2018/19 adoption of this Standard (ie an amended Chapter Seven, Financial

Instruments) is included in the 2017/18 Code. As CIPFA/LASAAC will see from the overview of IFRS 9 in the subsequent paragraphs accounts preparers will need adequate preparation time to adopt the Standard. There are numerous issues including new classifications, new models for impairment, detailed transitional requirements and new disclosure requirements. General commentary on implementation of the Standard indicates that it will take the commercial sector some substantial time to make adequate preparations for the Standard and these issues will be similar for local authorities. Additionally, the Secretariat understands this is similar to the approach anticipated for the FReM.

CIPFA/LASAAC is invited to agree the approach to implementation outlined overleaf and in 08 03-16.

Technical Working Group

2.4 CIPFA/LASAAC members will be aware that the Secretariat has been working with HM Treasury and the other relevant authorities on the adoption of both IFRS 9 and IFRS 15. CL 08 11-15 informed members of the constitution of the Technical Working Group (TWG) and the local authority accounts preparer membership invited to attend the Group[1].

Consultation Responses

2.5 CIPFA/LASAAC will be aware that the Invitation to Comment (ITC) on the 2016/17 Code included an overview of IFRS 9 and sought interested parties' views on the approach to adoption. Where relevant the Secretariat has been able to include any relevant commentary from the consultation responses in this report.

3 Classification and Measurement of Financial Assets

3.1 IFRS 9 applies a single classification and measurement approach to all types of financial assets. IFRS 9 replaces most of the guidance in IAS 39 *Financial Instruments; Recognition and Measurement* and has changed the categories for classifications for financial instruments. The existing classifications of held-to-maturity, loans and receivables and available-for-sale financial assets have been removed. Classification determines how financial assets are accounted for in financial statements and subsequent measurement.

3.2 The measurement categories for financial assets reflect the nature of their cash flows and the way they are actually managed as a group and the classes of financial asset are:

- financial assets measured at amortised cost (AC)
- financial assets measured fair value through other comprehensive income (FVOCI)
  - this classification is separated between debt instruments and those equity instruments that are not held for trading that IFRS 9 permits to be designated as FVOCI where the fair value for those instruments is never recycled through profit or loss, and

[1] The comments relating to the Technical Working Groups may be found in the Annex to the HM Treasury Report to FRAB 19 November 2015 which is available by means of the attached link: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/495312/FRAB_125__2_3__Annex_A_IFRS_9_and_15_FD_Consultation_october_2015_v1_3__....pdf

- financial assets measured at fair value through profit or loss (FVPL).

3.3 The classification criteria under the Standard are now principles based to allocate instruments to each class of financial assets. Two criteria are used to determine how financial assets should be classified and measured:

- the entity's business model for managing the financial assets; and

- the contractual cash flow characteristics of the financial asset.

3.4 The classification and subsequent measurement of financial assets under IFRS 9 is as follows:

- AC - where a financial asset meets the criterion that their contractual cash flows are solely payments of principal and interest (SPPI) and their business model for holding a group of financial assets is to collect contractual cash flows.

- FVOCI – where a financial asset meets the criterion of SPPI for their contractual cash flows and where the business model for that group of financial assets is to hold the assets to both collect contractual cash flows and sell financial assets. See also 3.2 above for those equity instruments designated at FVOCI.

- FVPL – all other financial assets are measured at fair value through profit and loss.

3.5 Classification is important as a change in the measurement requirements will have an impact on what is recognised in the balance sheet and profit and loss.

3.6 The Secretariat would note that, as IFRS 9 is principles based, substantial judgment will be required for the assessment of both the contractual cash flow characteristics (where there are new terms that will need to be understood by accounts preparers) and the business model tests. More detail on how the business model might apply to local authorities is attached at Appendix A.

3.7 The business model can be observed based on the facts and circumstances of the entity, how an entity is managed, and by the type of information that is provided to its management. It is also acknowledged that an entity might have more than one business model. Where an entity has a number of different objectives (or business models) for managing financial assets, management will have to make an assessment about the level the business model is to be applied.

3.8 Contractual cash flows meet the SPPI criterion if the contractual terms of the financial asset only give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding on specified dates i.e. the contractual cash flows are consistent with a basic lending arrangement. Consideration will need to be made of both elements of the criterion ie principal and interest. Deciding whether the SPPI criterion is met will require an assessment of contractual provisions that do or may change the timing or amount of the contractual cash flows.

3.9 Although technically complex and requiring substantial preparation by accounts preparers, the Secretariat cannot see any specific need to interpret or adopt the general provisions of IFRS 9 for classification and measurement though it would like to bring the classification of equity instruments not held for trading to the attention of the Board (see paragraphs 3.10 to 3.14 below).

CIPFA/LASAAC members are invited to consider the approach to classification of financial instruments above (with the exception of the classification of equity instruments not held for trading).

3.10 Classification was an issue for a significant group of respondents to the last year's consultation on IFRS 9. A number of the respondents raised the issue cited in the consultation that the introduction of IFRS 9 will see the removal of the available- -for-sale classification in the Code (which is the "default category" under IAS 39) and allowed gains and losses to be held in reserves until realised. The respondents were concerned that the default category under IFRS 9 is FVPL and thus adoption may result in gains from changes in fair value and hitting the Surplus or Deficit on the Provision of Services as they arise.

3.11 The respondents considered that they needed the ability to designate the equity instruments they held as FVOCI discussed above (see also paragraph 5.7.5 of IFRS 9). The respondents highlighted the current prohibitions against designation in the Code and commented that if the Code does not permit the designations in paragraph 5.7.5 there may be unwanted volatility if these instruments were to be classified as FVPL.

3.12 The Secretariat understands from the discussions at the TWG that the designation of equity instruments to the FVOCI classification was originally intended for investments held in equity instruments that were held for strategic purposes and not for investment returns. It should be noted that designation in this category will mean that gains and losses are not recycled on disposal. The cumulative fair value changes are required to remain in Other Comprehensive Income and are not subsequently recycled to profit or loss (or the Surplus or Deficit on the Provision of Services). Entities have the ability to transfer amounts between reserves within equity. For local authorities the equivalent would be a transfer to the General Fund Balance via the Movement in Reserves Statement.

3.13 The Secretariat considers that this designation may be appropriate for some strategic investments held by local authorities (eg in bus or airport companies) but there is a question of whether recognising gains or losses on disposal in Other Comprehensive Income and Expenditure will truly reflect the economic reality of the investments discussed by the respondents (pooled bond funds[2]). From the descriptions provided by respondents it appears that they are not wholly held for strategic purposes but as a part of the treasury management activities. It is not clear that these instruments should be classified in a measurement class where gains or losses are not recognised on derecognition in the Comprehensive Income and Expenditure Statement.

3.14 A counter argument would be that this is permitted by IFRS and there appear to be no other criteria that need to be met in the Standard other than the financial instrument should not be held for trading. The descriptions of the transactions in the consultation responses appeared to meet the criteria ie they did not appear to held for trading so could be designated at FVOCI. IFRS 9 does not include a qualification test that the investment has to be held for strategic purposes and therefore authorities could be allowed to make their own decisions under the Standard.

[2] A number of authorities commented on their use of pooled funds which included the use of Money Market Funds and noted the efficiency of these investment mechanisms including the wide diversification of risk.

CIPFA/LASAAC's initial views are sought on the approach to designation of equity instruments held by local authorities under IFRS 9.

3.15 The TWG that considered application of IFRS 9 in the public sector identified that the classification and measurement of financial assets is a sizeable change under the new Standard as it is a different approach to what has previously been used under IAS 39 – i.e. a move from rules-based categories to a principles-based approach to classification.

3.16 The TWG considered that accounts preparers should not start from the assumption that there will be an seamless mapping from IAS 39 and they should be considering how instruments are managed and the contractual cash flows (and variations of cash flows) of the instruments. This should also be factored into the approach to designation of equity instruments set out in paragraphs 3.10 to 3.14 above.

CIPFA/LASAAC is invited to provide any other comments on classification and measurement of financial assets under IFRS 9.

4 Impairment of Financial Assets

4.1 The new impairment requirements provide users of financial statements with more useful information about an entity's expected credit losses on financial instruments. IFRS 9 replaces the incurred loss model under IAS 39 with the expected loss model. The guiding principle for the model is that it requires an entity to recognise expected credit losses at all times and to update the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments.

4.2 This model is forward-looking and it eliminates the threshold for the recognition of expected credit losses, so that it is no longer necessary, as it was under IAS 39, for a trigger event to have occurred before credit losses are recognised.

Scope of Impairment Provisions

Impairment Model Applies	Impairment Model Does Not Apply (Outside scope)
Financial Assets Measured at Amortised Cost	Equity Instruments
Financial Assets Measured at FVOCI	Financial Instruments (including loan commitments) measured at FVPL
Lease receivables	
Loan Commitments (not measured at FVPL), Financial Guarantee Contracts and Contract Assets	
Trade receivables	

4.3 The main difference in scope to IAS 39 is that the measurement for certain loan commitments and financial guarantee contracts is based on the IFRS 9 impairment requirements rather than those of IAS 37 *Provisions, Contingent Assets and Contingent Liabilities*.

4.4 The amount of expected credit losses recognised as a loss allowance or provision depends on the extent of credit deterioration since initial recognition. An impairment loss allowance needs to be made even where there is no evidence of deterioration present. Under the general approach, there are two measurement bases:

- Twelve month expected credit losses (stage 1) which applies to items from initial recognition provided that there is no significant deterioration in credit losses. This is the portion of lifetime expected credit losses that result from default events possible within 12 months from the entity's reporting date. It is not the expected cash shortfalls over the next twelve months—instead, it is the effect of the entire credit loss. A provision will be recognised in profit or loss, leading to a 'day-one' provision.

- Lifetime expected credit losses (stages 2 and 3), which applies when a significant increase in credit risk has occurred on an individual or collective basis. Stage 3 of the model becomes applicable when there is objective evidence of impairment this is very similar to an incurred loss under IAS 39, and the financial asset has become credit impaired.

4.5 There are two key practical expedients that may be applied:

- Low credit risk instruments ie those financial instruments with low risk of default and strong capacity to repay – these instruments would remain in stage 1 and only 12 month expected credit losses provided for.

- 30 days past due rebuttable presumption – there is a rebuttable presumption that credit risk has increased significantly when contractual payments are 30 days past due.

4.6 In stages 1 and 2, there is a total decoupling of interest recognition and impairment. Therefore for these stages interest revenue is calculated by applying the effective interest rate method to the gross carrying amount (without deducting the loss allowance). If a financial asset subsequently becomes credit-impaired (stage 3), an entity is required to calculate the interest revenue by applying the expected interest rate in subsequent reporting periods to the amortised cost of the financial asset (i.e., the gross carrying amount net of loss allowance) rather than the gross carrying amount.

4.7 The Standard provides a simplified approach to the general model described above. The simplified approach requires recognition of a loss allowance based on lifetime expected losses from origination. An entity is required to apply the simplified approach for trade receivables or contract assets that result from transactions within the scope of IFRS 15 and that do not contain a significant financing component, or when the entity applies the practical expedient for contracts that have a maturity of one year or less, in accordance with IFRS 15. This means that stages 2 and 3 would apply as relevant.

4.8 However, an entity has a policy choice to apply either the simplified approach or the general approach for the following:

- All trade receivables or contract assets that result from transactions within the scope of IFRS 15 and that contain a significant financing component in accordance with IFRS 15. The policy choice may be applied separately to trade receivables and contract assets.

- All lease receivables that result from transactions that are within the scope of IAS 17. The policy choice may be applied separately to finance and operating lease receivables.

4.9 An entity should use all reasonably available information to determine if deterioration has occurred and the 12-month/lifetime expected credit losses it expects will be incurred. Under IFRS 9 an entity is to 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.

4.10 There was a diverse range of responses to the Code consultation questions on IFRS 9 last year. Some respondents considered that the expected loss impairment model will not overly change their profile of impairment recognition. Other respondents indicated that the lifetime expected model on trade receivables will be significant for authorities particularly in times of economic down-turn. (Although as noted above the simplified approach is likely to apply to local authority trade receivables). A number of respondents cited the possible impact on the collection fund for non-domestic rates and council tax receivables. However, see paragraphs 4.12 to 4.14 below.

4.11 The TWG on IFRS 9 considered, as relevant to local authorities, that:

- Accounts preparers should be aware of the significant difference in data collected and used in the new impairment model – i.e. if a provision matrix has previously been used then under IFRS 9 it needs to incorporate forward looking data and if basing assessments on historical default rates an assessment needs to be made on how this data was collected and whether it can be applied prospectively.

- Accounts preparers also need to have an understanding of how the new impairment model will impact profit or loss (Surplus or Deficit on the Provision of Services for local authorities) and the differences from IAS 39, for example, stage 3 of the model is similar to the IAS 39 incurred loss model in that the trigger is consistent but presenting the interest income on a net basis in stage 3 is a difference compared with the gross basis of stage 2 under IFRS 9. Measurement of losses may also be different under the new model.

4.12 It is notable that the impairment losses will need to be recognised earlier and are likely to have a budgetary effect on local authorities. The Secretariat cannot see an economic argument that impairment provisions within IFRS 9 need to be substantially interpreted or adapted for local authority circumstances. Again there will need to be substantial work required in preparation for the new requirement with data collection and systems issues that need to be considered in preparation for the move.

CIPFA/LASAAC's initial views are sought on the impairment provisions of the Standard and whether it agrees with the assessment of the Secretariat in relation to the impairment provisions in IFRS 9.

4.13 IFRS 9 includes within its scope rights and obligations within the scope of IFRS 15 *Revenue from Contracts with Customers*. Council Tax and income from National Non Domestic Rates do not meet the definition of income under IFRS 15 and instead meet the definitions of Tax in IPSAS *23 Revenue from Non-Exchange Transactions (Taxes and Transfers).*

4.14 The Code currently includes an adaptation of IAS 39 "*ie revenue relating to such things as council tax, general rates, etc shall be measured at the full amount receivable (net of any impairment losses) as they are non-contractual, non-exchange transactions and there can be no difference between delivery and payment dates*". This adaptation still includes impairment losses.

4.15 CIPFA/LASAAC will need to consider whether the expected impairment loss model will be consistent with the economic effect of council tax income streams and/or whether the non-financial asset receivable should be impaired under another Standard. The Secretariat considers that the general approach to impairment under IFRS 9 is unlikely to be appropriate following the approach to the adaptation outlined above. However, any impairment might usefully be considered either under the simplified approach to measuring expected credit losses or the IAS 39 incurred loss model.

CIPFA/LASAAC's initial views are sought on the approach to recognition of impairment losses for council tax, non-domestic rates etc.

5 Approach to Liabilities

5.1 The classification and measurement of financial liabilities in accordance with IFRS 9 remains largely unchanged from IAS 39. The main change relates to the accounting and presentation of changes in the fair value of an entity's own debt for financial liabilities for an entity's own credit status for financial liabilities that have been designated as at FVTPL. This change is expected mainly to affect financial institutions and in theory should not apply to local authorities.

CIPFA/LASAAC's initial views and comments are sought on the adoption for IFRS 9 for liabilities.

6 Current Adaptations

6.1 The 2016/7 Code includes the current adaptations to IAS 39. The following table include the Secretariat's initial suggestions for the approach under IFRS 9.

Adaptation	Approach under IFRS 9
'Regular way' trades of financial assets	
IAS 39 permits ether 'trade date' or 'settlement date' accounting to be used for 'regular way' trades of financial assets. This discretion is not permitted by the Code. The trade date rather than the settlement date shall be used to recognise the regular way purchase or sale of a financial asset.	Retain current provisions for consistency.
Designation of the category of a financial instrument	
Under IAS 39, subject to restrictions and is in certain circumstances an entity is permitted to 'designate' a financial instrument to a different category from the one to which it would inherently	The previous designations were permitted on the grounds of comparability. However, as some of the respondents to the Code consultations indicated this removed the flexibility to

belong under IAS 39. The Code does not permit such designations.	account for assets in the way in which they are held. IFRS 9 permits certain designations one of which is described in paragraphs 3.10 to 3.14 above. The Secretariat considers that the opportunity to designate should be considered for review as a part of the adoption of IFRS 9. IFRS 9 also provides an option at initial recognition to designate a financial asset to be measured as at fair value through profit or loss (rather than at amortised cost or FVOCI) if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities, or recognising the gains and losses arising from them, on different bases. It is unlikely that this designation would be necessary for local authorities.
The Adaptations for Soft Loans Received or Advanced	
The Code provides guidance for the prevailing interest rate for the purpose of estimating the fair value on initial recognition.	It is likely that this guidance needs to be retained.
Lender Option Borrower Option (LOBO) Loans	
The Code requires: ▪ options embedded in a LOBO are not separately accounted for unless after considering the contractual terms of the instrument the authority concludes that IAS 39 would require the embedded options to be accounted for separately, ▪ the contractual life and contractual cash flows shall be used as the expected life of a LOBO when calculating the effective interest rate on initial recognition, unless on considering the contractual terms of the instrument the authority concludes it is able to estimate reliably the expected cash flows or expected life.	As there are no changes in the accounting requirements for liabilities from the position in IAS 39, (other than for own credit risk) then it is suggested that these adaptations are retained.
Accounting for immaterial transaction costs on initial recognition	

The Code gives an option to write off immediately to Surplus or Deficit on the Provision of Services transaction costs that the Code would usually require to be applied to adjust a financial instrument's initial carrying amount, where they are immaterial.	If the transaction costs are immaterial then as such this guidance is not required in the Code. However, it is likely that accounts preparers find this clarification in the Code useful and therefore the Secretariat recommends that this provision is retained as an interpretation.
Exchanges of debt instruments	
The Code (and IAS 39) requires, under defined circumstances, the gain or loss on an exchange of debt instruments between an existing borrower and lender to be used to adjust the carrying amount, rather than be recognised immediately in Surplus or Deficit on the Provision of Services. The Code has interpreted this as requiring the exchange of loan instruments and associated settlement of any fees or costs incurred to take place on the same day and as not requiring net settlement as long as any payments between the lender and the borrower are made on the same day. Overwhelmingly the main lender to local authorities is the Public Works Loan Board (PWLB), which is not permitted to settle these amounts net but must receive payment of the agreed settlement amount of the original loan.	As there are no changes in the accounting requirements for liabilities from the position in IAS 39, (other than for own credit risk) then it is suggested that these adaptations are retained.

CIPFA/LASAAC's views are sought on the Secretariat's suggested approach to the use of adaptations and interpretations under IFRS 9.

6 Hedge Accounting

6.1 The objective of hedge accounting in IFRS 9 is to represent in the financial statements the effect of an entity's risk management activities when they use financial instruments to manage exposures arising from particular risks and those risks could affect profit or loss (or, if relevant, other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income). The Standard moves away from a very rules-based approach and has also 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.

6.2 Currently the Code's provisions on hedge accounting rely on substantial cross references to IAS 39 as otherwise the Code would only repeat substantial amounts of the Standard. The Secretariat is only aware of one local authority that undertakes hedge accounting and therefore suggests that this approach should be retained.

CIPFA/LASAAC's initial views are sought on the approach the adoption of IFRS 9 for Hedge Accounting in the Code.

7 Disclosures

7.1 IFRS 9 amends IFRS 7 *Financial Instruments; Disclosures* to include extensive new or amended disclosures. Some of the changes reflect the new classification requirements discussed in section 3 of this report. New disclosures are added for investments in equity instruments designated as at FVOCI, disclosures on risk management activities and hedge accounting and disclosures on credit risk management and impairment. If an entity has made a reclassification between amortised cost, FVOCI or FVPL for debt instruments as a result of a change in its business model, the Standard also includes disclosures for such reclassifications of financial assets. Disclosures are also required to support the transitional requirements of the Standard.

7.2 IFRS 9 has added new disclosures to IFRS 7 in relation to the new impairment model. The disclosures require 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
- expected credit losses (both quantitative and qualitative information) including changes in the amount of expected credit losses and the rationale for those changes, and
- an entity's credit risk exposure i.e., the credit risk inherent in its financial assets and commitments to extend credit (including where there is significant credit risk concentrations).

8 Transition

8.1 The general approach to transition in IFRS 9 is that retrospective application is required in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Standard includes an exception for the requirement to include comparative information, but, entities may choose to restate. If an entity elects not to restate there are specific transitional reporting requirements, including the quantification of the adjustments required to retained earnings and components of equity ie reserves for a local authority. If an entity does restate the use of hindsight is prohibited. There are transitional disclosures for both approaches.

8.2 In the HM Treasury report[3] on the adoption of both IFRS 9 and 15, the technical working groups agreed considerations of cost and effort should be regarded in considering the most suitable option for the public sector. The Secretariat concurs that on the basis of the resource implications for local authority accounts preparers and technical accounting reasons ie, for example, that IFRS 9 is not applied to financial instruments derecognised before the date of initial application

[3] See FRAB 125 (2 and 3)
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/494991/FRAB_125_IFRS_9_and_IFRS_15_update.pdf

(DIA)[4] then the option where comparative information is not restated would be the preferred option.

CIPFA/LASAAC's early views are sought on the approach to restatement of comparative information in the Standard.

8.3 The transitional arrangements for the adoption of the Standard are complicated. There a numerous arrangements for different aspects of the new requirements. This section focuses on examples which are most likely to apply to local authorities but does not provide an exhaustive list. For example, some of the transitional requirements focus on the date of initial application (DIA). The DIA is important as this is the date on which several key decisions must be made including:

- assessing the objective of the business models within which financial assets are held;
- designating equity instruments that are not held for trading as FVOCI,
- determining as a part of the assessment of impairment whether there has been a significant increase in credit risk since initial recognition or whether that determination would require significant cost or effort,
- IFRS 9 is not applied to financial instruments derecognised before the DIA.

8.4 There are other detailed transitional requirements and practical expedients including exceptions on transition for undue cost or effort. For example, if determining on the DIA that there has been a significant increase in the credit risk since initial recognition would require undue cost or effort then the impairment is measured at the lifetime expected credit losses at each reporting date until the financial asset is derecognised. A second example is on the DIA an entity is also not required to undertake an exhaustive search for information to determine whether there has been a significant increase in credit risk since the initial recognition of a financial asset. The transitional arrangements permit that the entity approximates credit risk on initial recognition by considering information that is reasonably available without undue cost or effort.

CIPFA/LASAAC's views are sought on whether the Board would like to follow the prescriptions in IFRS 9 for all the transitional options, relevant to local authorities or whether it would like to consider any more prescriptive approaches.

Recommendation

CIPFA/LASAAC is asked to consider the individual questions above and provide any other comments on the adoption of IFRS 9 in the Code.

[4] The DIA is defined by IFRS 9 as the beginning of the reporting period in which an entity first applies IFRS 9: ie, for local authorities 1 April 2018

Appendix A

Business model for holding financial assets for local authorities

Interpreting the business model in the public sector

Section 12 of the Local Government Act 2003 provides local authorities in England and Wales with the power to invest for any purpose relevant to its functions or for the prudent management of its financial affairs.

Local authorities in England are required to provide an investment strategy on an annual basis; this strategy is prepared in accordance with statutory guidance issued by the Department for Communities and Local Government, Guidance on Local Authority Investments. The statutory guidance is clear that investment priorities should be security and liquidity, rather than yield. Similar guidance is issued by the Welsh Government.

It is unlikely therefore that a local authority will hold financial assets for speculative purposes or for trading and therefore the business model that they will normally operate is to hold financial assets in order to collect contractual cash flows.

Local authorities formally produce an annual treasury management strategy in accordance with the CIPFA Code of Practice on Treasury Management before the start of a financial year and with mid-year reviews and year end reports.

In a limited review of a number of local authorities' treasury management strategies they aimed to ensure:

- security of the sums invested
- cash (and resources) are available to support expenditure plans over the short and longer- term
- investment returns are maximised commensurate with the authority's policy of minimising risks to the security of capital and its liquidity position

Some sales of financial assets are likely to take place in accordance with local authority treasury management activities but it is not clear whether the incidence of these sales is frequent or not. Sales might occur where financial assets no longer meet the requirements of credit criteria specified in a local authority's treasury management strategy. However, paragraph 4.1.3 b) of IFRS 9 confirms that this would still be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows.

It is unlikely that there would need to be any interpretation of the business model provisions for local authorities as authorities will be able to confirm under the provisions of the Standard whether their business model is to hold financial assets in order to collect contractual cash flows.

Financial assets held by local authority pension funds are held on a more commercial basis but still under statutory prescriptions. The arrangements for investing for local authority pension funds are specified in England and Wales in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. The Regulations require an administering authority, to prepare, maintain and publish a written statement of the principles (SIP) governing its decisions about the investment of Fund money.

The SIP must be reviewed and, if necessary, revised by the administering authority from time to time and, in the case of any material change in the authority's policies or breach of compliance, within six months of such change.

Typical investment objectives of local government pension funds are to ensure that the Fund is able to meet its liabilities for pensions and other benefits with the minimum, stable level of employer contributions. The investment objectives are also to maximise returns both in the medium to long-term but also to ensure sufficient liquidity to meet its shorter-term commitments. It is the normal process that a number of investment fund managers manage portfolios of pension fund financial assets against performance objectives.

As the pension fund business model operates in a more commercial environment than the main authority business model it is considered that sales of financial assets are relatively frequent and more likely to achieve their business objective by both collecting contractual cash flows and selling financial assets. However, again there is unlikely to be a need to interpret IFRS 9 for the pension fund accounts preparers to be able to assess their business model.

Alternatively the pension fund financial assets may more closely meet the description in paragraph B4.1.6 of IFRS 9 ie by holding portfolios of financial assets that are managed and whose performance is evaluated on a fair value basis (as described in paragraph 4.2.2(b)) of IFRS 9. The financial assets are neither held solely to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. It may be the case that the model that administering authorities of local authority pension funds utilises is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. These financial assets may under paragraph 4.2.2(b) be designated as at fair value through profit or loss. CIPFA/LASAAC will need to consult with CIPFA Pensions Panel whether or not the Code will need to be more prescriptive for local authority pension funds. However, it is likely that the standard will not need substantial interpretation.

Determining the level at which the business model is assessed in the public sector

IFRS 9 confirms a single entity may have more than one business model for managing its financial instruments. In local authorities it is likely that for most of its financial assets there will only be one model discussed above. It is possible, however, that some local authorities will hold some financial assets, for strategic purposes, for example equity shares in airports or bus companies and therefore not for the purposes of either business model. In these cases subject to CIPFA/LASAAC's views on the approach to designation the authority might consider holding these instruments as fair value through other comprehensive income.

Again with pension funds it is likely that the financial assets are held under one set of objectives which may lead to a single business model approach but local authority pension funds will be able to confirm this under the provisions of the IFRS 9 and it is unlikely that further interpretation of the Standard will be required.

Interpreting changes to the business model in the public sector

Both the treasury management activities for a local authority's normal treasury management activities and local authority pension funds set policy statements to be agreed on an annual basis and include opportunities to review. Changes in the objectives of the investment policy need to be subject to approval processes and it is likely that local authorities and the administering authorities for local government pension scheme funds will be able to follow the requirements of the standard without substantial interpretation to IFRS 9.