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 included in the Invitation to Comment and Exposure Draft

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), the issues to be included in the Invitation to Comment (ITC) on the Code and the approach to drafting the provisions in the Code.

2 Background – Developments to Date

2.1 CIPFA/LASAAC agreed at its last meeting that it would consult on including the provisions of IFRS 9 in the 2017/18 Code with an effective date of 1 April 2018. This would allow local authority accounts preparers to make effective preparations for the substantial changes required. The ITC therefore asks local authorities' views on this approach. The provisions on IFRS 9 will be included in a new Appendix F to the Code and will include the transitional provisions required to adopt the standard as it applies to local authorities.

Consultation Responses

2.2 In order to prepare for this substantial change the Board will remember that last year it consulted on the adoption of the Standard in the consultation on the 2016/17 Code. In addition the Secretariat prepared an early version of the Exposure Draft and consulted with CIPFA/LASAAC, the Treasury and Capital Management Panel and a sub-group of that Panel to inform the development of the Standard for the Code. With the exception of the issue of regular way trades of financial assets (see below) feedback was supportive.

2.3 The Secretariat contributed to the Technical Working Group which included HM Treasury and the relevant authorities under the Government's Financial Reporting

Advisory Board. This generated further commentary on the application of the Standard across the public sector and where relevant these comments have been used to develop the ITC and the Exposure Draft.

2.4 In order to stimulate debate from interested parties the ITC includes an overview of the requirements of IFRS 9 highlighting the areas of substantial change and a commentary and direction on the approach to adoption of the Standard as provided at the last meeting of the Board.

2.5 In drafting the new chapter seven the exposure draft has followed the approach in the original chapter seven of the Code. This chapter has been relatively unchanged since the 2010/11 Code. In turn that edition contained much of the approach to adoption since the move to the UK GAAP financial instruments standards in 2007. Chapter seven therefore includes areas which might be considered to be more akin to application guidance eg the provisions on amortised cost measurement, soft loans and regular way trades of financial instruments. As these were subject to substantial debate at the time the Secretariat has not removed these paragraphs but would welcome CIPFA/LASAAC's views on whether these paragraphs should be retained.

2.6 The Board will be aware that the financial instruments section of the Code combined three standards: IAS 39 *Financial Instruments: Recognition*, IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosure.* This covered four sections which the Secretariat has reduced to three (the fourth section now covering the transitional requirements). However, the provisions in IFRS 9 are more complex and more detailed than IAS 39, particularly for the provisions on impairment losses and the new disclosures. Chapter seven is therefore longer than the previous version.

2.7 The Secretariat has also removed the statutory accounting requirements for certain investments in Icelandic banks as it is of the view that these provisions will not be required by the 2018/19 Code.

CIPFA/LASAAC's views are sought on the approach to drafting the new Chapter Seven.

3 Classification and Measurement of Financial Assets

3.1 Following CIPFA/LASAAC's comments at the last meeting the Exposure Draft largely follows the approach in IFRS 9 for the new classification requirements for financial assets. This includes the provisions for designations of equity instruments as permitted under the Standard.

Equity Instruments Designated at Fair Value through Other Comprehensive Income

3.2 The designation of equity instruments at fair value through other comprehensive income was an issue raised by a significant group of respondents to last year's consultation on IFRS 9. A number of the respondents commented on a point 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) which allowed gains and losses to be held in reserves until realised. The respondents were concerned that if the instruments remained classified to the default category under IFRS 9 (ie fair value through profit or loss) this may result in gains and losses from changes in fair value hitting the Surplus or Deficit on the Provision of Services as they arise.

3.3 The respondents considered that they needed the ability to designate the equity instruments they held[1] as fair value through other comprehensive income 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. One authority included the following comment to demonstrate that volatility:

"An unrealised profit of around £1m in 2014/15 across all funds is, due to 'mark-to-market' valuation, showing a negative in 2015/16 to end of September of around £400K."

3.4 The Secretariat understands from the discussions at the TWG that the designation of equity instruments to the fair value through other comprehensive income classification was originally intended for investments in equity instruments that were held for strategic purposes and not for investment returns. This is supported in the basis of conclusions for IFRS 9 (BC5.21 to BC5.25). In its deliberations on the standard the basis of conclusions sets out that:

"*…the IASB noted arguments that presenting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment…"*

3.5 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.

3.6 The Secretariat considers that this designation is likely to 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 (ie 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. The descriptions of the transactions in the consultation responses appeared to meet part of the criteria (ie they did not appear to be held for trading) so if they are equity instruments could be designated at fair value through other comprehensive income. 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. However, both these issues are discussed in more detail below.

3.7 The commentary provided by respondents indicates that these instruments may take the form of equity instruments but it is not clear that they meet the substance of the definition in the standard ie IAS 32 *Financial Instruments: Presentation*. Commentaries discovered during the Secretariat's research on

[1] 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

[2] (see footnote 1)

money market funds indicate that some commentators are of the view that certain money markets funds do not meet the definition of equity due to the redeemable nature of the investments.

3.8 The Basis of Conclusions sets out that the IASB did consider developing a principle to identify other equity investments whose fair value changes should be presented in profit or loss (or other comprehensive income), including a distinction based on whether the equity instruments represented a 'strategic investment'. However, the IASB decided that it would be difficult, to develop a clear and robust principle that would identify investments that are distinct enough to warrant a different presentation requirement (IFRS 9 BC5.25).

3.9 IFRS 9 amended IFRS 7 in 2009 to require additional disclosures about investments in equity instruments that are measured at fair value through other comprehensive income. Importantly IFRS 7 requires disclosures for *each* equity instrument and disclosures explaining why an entity has decided to designate the instruments to other comprehensive income (see IFRS 7 paragraph 11A and Exposure Draft of the Code paragraph 7.3.2.4) providing a disincentive for this to be a regular or frequent transaction for an entity. The Secretariat therefore recommends that as authorities may have strategic investments that might justify the designations that CIPFA/LASAAC retains the ability to designate supported by the disclosure approach in the standard.

3.10 It is not clear, however, 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. It appears that there are some money market funds and pooled funds that do not meet the intentions of the standard to be designated through other comprehensive income and may not meet the definition of an equity instrument. If this is the case and these instruments should instead be classified as fair value through profit or loss, this could lead to the volatility for the Surplus or Deficit on the Provision of Services highlighted by the respondents and could lead to volatility for the calculation of council tax and general fund balances.

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

Reclassification of Financial Assets

3.11 IFRS 9 includes substantial provisions on reclassifications of financial assets. Such reclassifications are required if and only if the objective of the entity's business model for managing those assets changes. These changes are expected to be very infrequent and are determined by an entity's senior management. The Secretariat would contend that these changes are likely to be even more infrequent for local authorities and has therefore not included substantial provisions in the Code on this issue.

3.12 The Exposure Draft for the Code therefore only includes brief mention of these provisions in the Standard and requires local authorities to refer directly to IFRS 9 where such changes occur. A similar approach has been taken to the disclosures required for reclassification where IFRS 9 has amended IFRS 7 to include substantial disclosure requirements when an entity makes such reclassifications. See Appendix A to this paper which summarises the disclosure requirements introduced by IFRS 9. Note that this paper was drafted for the Technical Working Group for the standard as it would apply across entities reporting under the FReM and therefore a number of the transactions are unlikely to apply or would be prohibited by the approach in the disclosure draft.

CIPFA/LASAAC is invited to consider whether it agrees to the approach to the drafting for reclassifications for IFRS 9 and IFRS 7.

Designations of Financial Instruments to Fair Value through Profit or Loss

3.13 IFRS 9 permits designations of both financial assets and financial liabilities to a fair value through profit or loss classification if doing so:

i) eliminates or significantly reduces a measurement or recognition inconsistency (known as an accounting mismatch), and

ii) for financial liabilities – a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy.

3.14 The 2016/17 Code currently prohibits all designations on the grounds of comparability and consistency. The Secretariat considers that the circumstances set out in IFRS 9 for designations outlined above are unlikely to exist for local authorities and therefore has included an adaptation to prohibit such designations.

CIPFA/LASAAC is invited to consider whether it agrees to the approach to the prohibition of designation of financial instruments at fair value through profit or loss in the Exposure Draft of the Code.

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. As discussed during CIPFA/LASAAC's last meeting, the approach to drafting for the Exposure Draft for impairment of financial assets has followed IFRS 9 without interpretation or adaptation. The ITC includes an overview of the standard and outlines the likely impact the standard will have on local authorities.

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.

Impairment of Council Tax, Rates and Non-Domestic Rates

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

4.3 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*". The Secretariat considers that this adaptation should be retained under IFRS 9. However, this adaptation still includes impairment losses. Section 3.6 of the Code specifies that the approach to the recognition and measurement of impairment losses follows the approach in IAS 39.

4.4 The provisions for accounting for impairment will therefore need to be considered under the move to IFRS 9. The Secretariat is of the view that the expected impairment loss model is not consistent with the economic effect of council tax income streams. It considers that impairment losses for council tax, non-domestic rates and district rates would not properly be reflected in the financial statements if they were based on expected credit losses, as the assessment of impairment cannot be based on the credit worthiness of the tax payers. It therefore proposes to retain the approach in the Code for these income streams and base these impairment losses on the incurred loss model in IAS 39. The Secretariat has included new paragraphs in Section 2.8 to restate the requirements of IAS 39 as they would apply specifically to the debtor balances for council tax etc.

CIPFA/LASAAC is invited to consider whether it agrees to the approach outlined above and in the Exposure Draft for the estimation of impairment losses for council tax 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 when the entity has chosen to measure that debt at fair value under the fair value option. This change is expected mainly to affect financial institutions and should not apply to local authorities.

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

6 Current Adaptations

6.1 The 2016/7 Code includes a number of adaptations to IAS 39. At its last meeting CIPFA/LASAAC agreed to maintain the current adaptations in the Code with the exception of a review of the approach to designations. The ITC and Exposure Draft reflect this approach. The designations for financial instruments at fair value through profit or loss are outlined in paragraphs 3.13 to 3.14 above. The designation of equity instruments at fair value through other comprehensive income is discussed in paragraphs 3.2 to 3.10.

6.2 Paragraphs 7.2 to 7.3 discuss the possibility of an adaptation for hedge accounting.

CIPFA/LASAAC's views are sought on whether it is content to retain the remaining adaptations listed in the Exposure Draft at paragraph 7.1.1.3.

Trade Date or Settlement Date Accounting

6.3 As a part of the consultation on the (early draft of the) Exposure Draft to IFRS 9 in the Code one authority respondent expressed the view that the approach to settlement date or trade date accounting should reflect the standard.

"*We would prefer to retain the option available under IFRS 9 to use settlement date accounting; as the usage of trade date accounting has the potential to result in an effective "double count" of investment balances. For example, in a situation where there is a market standard two day lag between placing a trade for an investment, and the settlement date; in the situation where a short-term investment is due to mature, and the entity wishes to roll it into a new investment, the entity will need to enter into a new trade two days before the maturity date of the existing investment. During that two day interval, both the existing investment and the new investment will be recorded on the books under trade date accounting. We feel this is potentially misleading*."

6.4 This authority responding to the question is most likely to hold more complex financial instruments and therefore has a good understanding of the transaction and its impact. Although unlikely to affect other authorities substantially, if it has a detrimental effect on the accurate presentation of the performance of an authority then the Secretariat considers that serious consideration should be given to removal of this adaptation. It might be the case, for example, as other authorities venture into more complex financial investments that more authorities may be similarly affected by such provisions.

6.5 Currently the Code has retained the approach to trade date or settlement date accounting that it had for IAS 39 so that members can consider these provisions in more detail. If CIPFA/LASAAC decided to remove the adaptations then the relevant paragraphs 7.1.3.6 and 7.1.3.7 could be removed as authorities would be able to refer directly to the Standard.

CIPFA/LASAAC's views are sought on the whether it wished to retain the current adaptation and seek further views during the consultation or to consult with the adaptation removed.

7 Hedge Accounting

7.1 Currently the Code's provisions on hedge accounting rely on cross references to IAS 39 as otherwise the Code would only repeat substantial parts of the Standard. The Secretariat is only aware of a few local authorities that undertake hedge accounting and therefore suggests that this approach should be retained under the adoption of IFRS 9. This was generally agreed by the Board at its meeting in March. CIPFA/LASAAC, however, wanted to consider whether this has any impact on the Group Accounting policies or financial statements and this issue has been raised in the Invitation to Comment.

7.2 IFRS 9 provides entities with an accounting policy choice between applying the hedge accounting requirements of IFRS 9 and continuing to apply the existing hedge accounting requirements in IAS 39 for all hedge accounting until its project on the accounting for macro hedging is completed.

7.3 The new hedge accounting requirements in IFRS 9 aim to provide improved accounting policies by providing a closer relationship between an entity's risk management strategy, including the rationale for hedging and disclosing the impact of hedging on the financial statements. Conceptually therefore as these are improved accounting policies over those of IAS 39 and as local authorities (largely) have not applied IAS 39 hedge accounting requirements, the Secretariat recommends that to simplify the approach and provide longevity in the provisions of IFRS 9 that only the IFRS 9 accounting policies should be offered in the Code. This issue of the choice of accounting policy was also raised by a FRAB member at the last meeting of the Board. The Code Exposure Draft and the ITC have been drafted from this perspective. It also includes a question to test the approach with local authority accounts preparers.

CIPFA/LASAAC's views are sought on the approach the adoption of IFRS 9 for hedge accounting in the Code.

8 Disclosures

8.1 IFRS 9 amends IFRS 7 to include extensive new or amended disclosures. Some of the changes reflect the new classification requirements discussed in section 3 of this report – see particularly the disclosure on the carrying value of financial instruments and the gains or losses recognised in the Comprehensive Income and Expenditure Statement. Substantial new disclosures are added for investments in equity instruments designated as at FVOCI and there are new disclosures on risk management activities particularly as relevant for hedge accounting and disclosures on credit risk management and impairment.

8.2 The disclosures required include both narrative requirements and financial information in a tabular format. Attached at Appendix A is the paper the Secretariat prepared for the Technical Working Group on the disclosures. As set out earlier it should be noted that these disclosures should be able to be substantially reduced for most local authorities because:

i) the IFRS 9 options that are proposed to be reduced in the Exposure Draft, and

ii) the variety of transactions will not exist for local authorities.

8.3 The Secretariat has challenged the applicability of the disclosures local authorities and has removed disclosures relating to collateral because local authorities are largely prohibited from pledging collateral and do not regularly require collateral for the financial instruments from other bodies.

8.4 In addition the disclosures relating to financial instruments designated at fair value through profit and loss are not included in the Exposure Draft.

8.5 It is recommended that the disclosures on reclassifications are also not included though the Code in an approach similar to the main provisions on reclassification. The Code will state that direct reference would need to be made to IFRS 7 if an authority does reclassify its financial assets. The relevant disclosures are currently included in section 7.3 (see paragraphs 7.3.2.6 to 7.3.2.8).

8.6 Despite the removal of these disclosures there are still substantial financial instruments disclosures that may apply to local authorities. The Exposure Draft emphasises the need to consider whether these transactions and disclosures are material to a local authority's financial statements. The Exposure Draft also seeks interested parties' views on whether there are other disclosures which can be removed if they are unlikely to apply to a local authority.

CIPFA/LASAAC's views are sought on the approach to drafting the ITC and Exposure Draft for the disclosures introduced by IFRS 9.

8.7 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 a reconciliation of the 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 are significant credit risk concentrations).

8.8 Appendix A illustrates how some of the tabular disclosures might look for the expected credit losses.

8.9 Paragraph 35C of IFRS 9 specifies that for expected credit losses an entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to other statements, such as a management commentary or risk report that is available to users of the financial statements on the same terms as the financial statements. The Secretariat has included reference to local authority Treasury Management and Investment Strategies as this information is required by the Code of Practice on Treasury Management and by statutory prescription and is published annually (see paragraph 7.3.3.8).

CIPFA/LASAAC's views are sought on whether they are content with cross referral to the Treasury Management and Investment Strategies approach.

9 Transition

9.1 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 they can do so without the use of hindsight. If an entity elects not to restate there are specific transitional reporting requirements, including the quantification of the adjustments required to retained earnings ie reserves and other components of equity. There are transitional disclosures for both approaches.

9.2 At its last meeting CIPFA/LASAAC agreed to opt for the transitional approach where prior year information is not restated and the Exposure Draft of Chapter seven now includes a separate section on transition which will be removed for the 2019/20 Code.

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

9.3 The Exposure Draft of the transitional arrangements follows on from the decision to not include preceding year information. It includes the relevant requirements and including the relevant practical expedients ie:

- initial classification of financial assets under the new requirements, including practical expedients on the time value of money for the solely payments of principal and interest test

- assessing the objective of the business models within which financial assets are held
- designating equity instruments that are not held for trading at fair value through other comprehensive income
- 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
- practical expedients for the application of the use of the effective interest method retrospectively, and
- treatment of equity instruments which were previously measured at cost under the standard.

9.4 There are other detailed transitional requirements and practical expedients for the move to the new impairment provisions the main provisions being: requiring an authority to use reasonable and supportable information on the 1 April 2018 that is available without undue cost and effort and if determining whether there has been a significant increase in credit risk since initial recognition would require undue cost and effort an authority is allowed instead to measure lifetime expected credit losses at each reporting date until the financial asset is derecognised.

9.5 There are also transitional reporting requirements for hedge accounting and the Exposure Draft requires direct reference to IFRS 9 and IFRS 7 for these requirements.

CIPFA/LASAAC is invited to consider the transitional reporting requirements under both IFRS 9 and IFRS 7 and whether it agrees with the approach in the Exposure Draft.

9.6 The transitional requirements are supported in the Standard by a number of disclosures recording the effects of and decisions taken on transition. Disclosures are required for the reclassifications required by the move to IFRS 9, including qualitative information and the effects of those reclassifications. These have been edited by the Secretariat to reflect the decision that the Board has made in relation to not requiring presentation of information for the preceding year.

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 as set out in the Exposure Draft and the Invitation to Comment.