

17 June 2010

**GOVERNMENT FINANCIAL REPORTING  
MANUAL (FReM) EXPOSURE DRAFT No:**

**(10)02**

EXPOSURE DRAFT OF PROPOSED

**AMENDMENTS TO THE FReM**

**Accounting for Loans, Public Dividend Capital  
(PDC) and Investments Outside the Departmental  
Boundary**

Comments to be received by 9 September 2010 (revised date)



HM TREASURY

## **ASSURANCE AND FINANCIAL REPORTING POLICY TEAM HM TREASURY**

This exposure draft of proposed amendments to the Government Financial Reporting Manual (FReM) is published by HM Treasury for comment only. The proposals may be modified in the light of comments received in this consultation process before being presented to the Financial Reporting Advisory Board for its approval. Final proposals approved by the Financial Reporting Advisory Board will be published as amendments to the FReM from the proposed effective date.

Comments on this exposure draft should be submitted in writing so as to be received by 9 September 2010. Respondents are asked to send their comments electronically to [FReM.consultation@hm-treasury.gov.uk](mailto:FReM.consultation@hm-treasury.gov.uk).

All responses will be published on the FReM website unless the respondent requests confidentiality.



**HM TREASURY**

# CONTENTS

*pages*

## **PROPOSED AMENDMENTS TO THE GOVERNMENT FINANCIAL REPORTING MANUAL (FReM)**

<b>Introduction and Invitation to Comment</b>	<b>4</b>
<b>Background</b>	<b>5</b>
<b>Proposal</b>	<b>9</b>
<b>General Questions</b>	<b>10</b>
<b>Proposed Amendments to:</b>	
<b>Chapter 4, Accounting Boundaries</b>	<b>12</b>
<b>Chapter 9, Financial Instruments</b>	<b>12</b>
<b>Annex</b>	<b>13</b>

## Proposed amendments to the FReM

### Introduction

The Assurance and Financial Reporting Policy team, HM Treasury, has published this exposure draft of proposed amendments to the Government Financial Reporting Manual (FReM) as part of its ongoing work to ensure that the Manual reflects the latest developments in government financial reporting.

### Structure of exposure draft

The exposure draft includes a section for each FReM chapter for which an amendment is proposed. Each section includes:

- (a) An explanation of why the amendment is proposed;
- (b) When necessary, any specific additional question unique to that proposed amendment;
- (c) The paragraphs of the FReM chapter that are affected by the proposed amendment;
- (d) The proposed effective date of each proposed amendment.

### Invitation to comment

HM Treasury invites comments on the proposed amendments. It would particularly welcome answers to the questions set out below. Comments are most helpful if they:

- (a) Answer the question as stated;
- (b) Indicate the specific paragraph or paragraphs to which they relate;
- (c) Contain a clear rationale; and
- (d) Describe any alternative HM Treasury should consider.

HM Treasury will consider all comments received in writing by 9 September 2010. In considering the comments, HM Treasury will base its conclusions on the merits of the arguments for and against each alternative, not on the number of responses supporting each alternative.

<b>Accounting for Loans, PDC and Investments Outside the Departmental Boundary</b>	
Why the amendments are proposed	<p>The FReM requires that Loans, Public Dividend Capital (PDC) and investments in public sector entities outside the departmental boundary be reported at historic cost, less impairment. The Treasury has reviewed this requirement (in relation to the valuing of banking investments that are currently classified to the public sector) and subject to this consultation it is proposed that the interpretation to measurement requirements under IAS 39 <i>Financial Instruments: Recognition and Measurement</i> be maintained solely for PDC, allowing reporting at cost less impairment and that IAS 39 is applied in full to loans and investments in entities outside the boundary.</p> <p>The proposed amendments seek to change the FReM so that it aligns with the requirements of IAS 39, where there are no public sector specific reasons to account differently.</p>
Paragraph(s) affected by the amendments	<p><b>Chapter 4 – paragraph 4.2.4</b></p> <p><b>Chapter 9 – paragraph 9.2.7 c)</b></p>
Proposed date	<b>2011-12</b>

1. The purpose of this paper is to provide the background to and details of proposed changes to the FReM for measuring the value of loans, PDC and investments in entities outside the departmental boundary, and to seek responses from central government bodies on the proposed changes to the FReM. The responses should consider the accounting and budgeting impacts.

### **Measurement of Loan, PDC and Investments in Public Sector Entities Outside The Departmental Boundary**

#### ***Background***

2. The FReM (para 9.2.7 c) requires that loans, PDC and investments in bodies designated as outside the departmental boundary be reported at historic cost, less impairment as an interpretation to IAS 39. This was also the FReM requirement under UK GAAP.

3. The FReM (para 4.2.12) sets out the entities outside the departmental boundary. FReM paragraph 4.2.3 states the departmental boundary is based on in-year budgetary control. This is different from the concept of control under IFRS (IAS 27), which is based on 'strategic' control. On this basis, NDPB's, trading funds and public corporations are outside the departmental boundary (para 4.2.12) and therefore not consolidated.

4. The validity of measuring certain types of investments in entities outside the boundary at cost (namely the banking investments) was first raised by the NAO and was considered in light of the consolidation option being closed by the FReM boundary and whether it was appropriate to measure the banking investments at cost less impairment. Were IAS 27 applied in full, the measurement issue under IAS 39 would not have applied.

5. The existing FReM requirement for historic cost accounting for investments was previously agreed in the context of investments that were not going to be available for sale and hence would not have a market against which to measure fair value. The ownership of banking shares by the Treasury has been a key driver in reviewing the requirement.

6. The Government's intervention to stabilise the financial markets and the new relationship with the banks requiring taxpayer support has resulted in an ONS classification of these banks as public financial corporations in the public sector. These investments have been valued at fair value in HM Treasury's financial statements, as there is observable market data to reflect the share value. For the 2008-09 resource accounts, HM Treasury has recorded these investments at fair value with Treasury agreement on FRAB advice, overriding the FReM requirement to measure at cost.

### **FRAB Consideration**

7. At the 23 April 2009 FRAB meeting, the Treasury sought advice on whether fair value accounting should apply to bank investments which fall outside the boundary. It was agreed that fair value should apply to the bank investments. Furthermore, the Board asked the Treasury to consider whether the measurement interpretation of IAS 39 should be removed, given that it would allow for fair value to be applied where appropriate but was also likely to result in historic cost less impairment being retained in most other cases. One concern was whether much work would be required to work through the fair value option before concluding that historic cost applied.

8. The FRAB advised, that subject to further review and full consultation, their preference is for the removal of the FReM requirement to measure Loans, Public Dividend Capital and other interests in public bodies outside the departmental boundary at historical cost, less any impairment.

9. Subsequently, at 3 June 2010 FRAB meeting, the Board confirmed the Treasury view that measurement of PDC should remain at cost less impairment, on the basis that it PDC does not fit into any measurement classification provided in IAS 39 (further outlined in paragraphs 16 to 18) and has previously been considered in detail by the FRAB.

## **IAS 39 Financial Instruments**

10. IAS 39, *Financial Instruments*, at para 43 requires initial measurement of financial instruments to be at fair value and subsequent measurement (para 46), determined by its classification category. Para 46 also states that all financial assets are measured at fair value, except ‘loans and receivables’ and ‘held to maturity’ which are measured at amortised cost using the effective rate method. IAS 39 Para 46(c) also allows “investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured” to be measured at cost.

11. IAS 39 para 48A requires that where the market for a financial instrument is not active, an entity should establish fair value by using a valuation technique. This paragraph then provides characteristics to consider in determining the valuation technique to use.

12. IAS 39, AG80 and AG81 clarify that fair value measurement for equity investments is precluded where the measurement models give very inconsistent values depending on the model used. This indicates that to adopt a cost basis, entities would need to show that a fair value basis is not possible or appropriate. That is, measuring at cost is not an elective option but should only be selected when the result of analysis shows that cost is the most appropriate measure for that instrument.

### **Loans**

13. Applying IAS 39 without interpretation would require the measurement for loans on initial recognition to be at fair value (which is most likely to be cost) with subsequent measurement at amortised cost. These assets will be subject to impairment.

14. The FReM interpretation on measurement of financial instrument at para 9.2.7d) states that “where future cash flows are discounted to measure fair value, entities should use the higher of the rate intrinsic to the financial instrument and the real discount rate set by HM Treasury as applied to the flows expressed in current prices”. Student loans are accounted for following IAS 39, using this FReM interpretation to measure fair value of the loan, and the subsidy is recorded as an impairment

15. Applying IAS 39 in full to loans is likely to be relatively straightforward. Initial soundings of some central government entities indicate that this should not be too difficult to implement. However it expected that this consultation will draw out any issues to be considered, for example, other subsidised loans that currently use the FReM interpretation.

### **Public Dividend Capital**

16. The FReM at para 9.2.4 states that “Public Dividend Capital (PDC) is not an equity instrument as defined in IAS 32”, *Financial Instruments: Presentation*. The particular definition is that the contract should evidence a residual interest in the assets of an entity after deducting all of its liabilities.

17. Other indicators that it does not meet the equity definition being it cannot be liquidated easily and is not issued by the entity. Conversely, it does provide financing and

dividends are payable, which are characteristic of equity. Furthermore, it does not meet the definition of a loan as it does not require interest payments or repayment of principal.

18. PDC does not neatly fit any one category of financial instruments, therefore it would be difficult to determine the classification to adopt before measurement can be considered. Any move to applying IAS 39 in full could be difficult. If it were defined as equity in the FReM, fair value measurement is likely to be cost in all cases.

19. The issues related to PDC were discussed at the 3 June 2010 FRAB meeting, and the Board agreed to maintain the FReM interpretation for measurement of PDC, continuing to require PDC to be measured at cost less impairment. This decision is reflected in the proposal included at paragraph 30.

### **Other Interests in Public Bodies Outside the Departmental Boundary**

20. Investments in public bodies outside the departmental boundary usually include ownership of shares in public corporations. Generally the shares are not traded on the open market and there is no market for the holdings. Usually they are 100% government owned.

21. Investments in public corporations (such as are, National Air Traffic Services Holdings Limited, Partnerships UK, Royal Mail Holdings plc, Enrichment Holdings Limited) should be measured at cost less impairment as required by the FReM. As noted in paragraph 5, this was in the context of lack of trading potential and no readily available market values. Indeed, even if the interpretation in the FReM were removed, for many investments it is likely that cost would still be the best approximation to fair value.

22. Under IAS 39, the investments in public bodies outside the departmental boundary would be measured at fair value, and as noted above in paragraph 21 the conclusion for some investments may be that cost is the best measurement option.

23. However, it may be possible to consider measurement options like net asset values as a proxy for fair value. Some departments currently account for such investments at cost, as required by the FReM but also provide further disclosure in the notes to the accounts and include for example, net asset valuation of their investments. Net asset values provide a basis of measurement which is well understood but IAS 39 para 48A requires that the chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity specific inputs.

24. The implementation of the financial instrument standards in the central government sector has introduced many new assets and liabilities, such as financial guarantee contracts and derivatives. The measurement of which occurs without interpretation or adaptation and has required use of judgement and valuation models. Therefore the Treasury's view is that IAS 39 should be applied in full to investments in entities outside the departmental boundary, unless there continues to be sufficient public sector policy reasons to maintain the interpretation. It is proposed that investments in bodies designated as outside the departmental boundary be accounted for as required by IAS 39 without interpretation or adaptation. It is expected that this consultation will draw out any public sector suitable options on valuation methodology.

## **Phased Replacement of IAS 39: *Financial Instruments: Recognition and Measurement* and Development of IFRS 9: *Financial Instruments***

25. The IASB has an aggressive work program to replace IAS 39 by the end of December 2010. The work completed to date on classification and measurement is reflected in IFRS 9. This requires all financial assets to be classified on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset. The classification and measurement has been simplified to either fair value or amortised cost, with defined boundaries for use of amortised cost.

26. IFRS 9 is not yet EU adopted and therefore an impact paper has not been presented to the FRAB. However IFRS 9 does not fundamentally impact the principle of the issues considered in this paper. When it is EU adopted, further consideration will be given as to whether interpretations or adaptations are required.

27. Further information on the changes to IAS 39 and a summary of IFRS 9 is provided in the Annex.

### **Invitation to comment**

28. Central government entities are required to submit their view on the proposal in this consultation, including the likely impacts on accounting and budgeting. The impact assessment should include measurement limitations and any other suitable options not considered in this ED.

29. The consultation is also expecting to draw out any potential cost implications of applying the standard in full, in effect the cost of gathering valuations. There is also likely to be budgeting impacts due to movement in valuation, therefore any issues related to potential volatility should be provided. Information on any potential benefits should also be provided.

### **Proposal**

30. This paper proposes to maintain the FReM measurement interpretation to IAS 39 solely for PDC, so that:

- all PDC continue to be measured at cost less impairment,
- loans apply IAS 39 in full, and
- investments in entities outside the boundary apply IAS 39 in full.

31. In providing responses to the proposal, respondents should consider the consequences of applying IAS 39 in full, including an assessment of the accounting impact (including measurement limitations), the budgetary impact, any public sector specific reasons for maintaining the interpretation to IAS 39 and any other suitable options not considered in this paper.

## **General questions**

### Question 1

Do you agree with the HM Treasury's proposal to amend the FReM to maintain the interpretation solely for PDC so that:

- PDC be measured at cost less impairment,
- loans apply IAS 39 in full, and
- investments in entities outside the boundary apply IAS 39 in full.

If not, why not, and what alternative do you propose for each investment type?

### Question 2

Do you agree with the proposed effective date of 1 April 2011. If not, why not, and what alternative do you propose?

FReM chapters addressed

The following table shows the topics addressed by these proposed amendments.

<b>FReM Chapter</b>	<b>Subject of amendment</b>
<b>Chapter 4, Accounting Bodies</b>	Paragraph 4.2.4 has been amended to reflect the requirement to apply IAS 39 without interpretation.
<b>Chapter 9, Financial Instruments</b>	Paragraph 9.2.7 c) has been amended to reflect the requirement to apply IAS 39 with interpretation for PDC alone.

## **Proposed amendment**

### **Government Financial Reporting Manual Chapter 4 - *Accounting Bodies* and Chapter 9 – *Financial Instruments***

#### Introduction

Amendments to Chapter 4 – *Accounting Bodies* are proposed and Chapter 9 – *Financial Instruments*.

#### Why the amendments are proposed

The amendment proposed in this Exposure Draft seeks to amend the FReM so that it aligns more closely with the measurement requirements of IAS 39, with only one interpretation.

#### Proposed amendments

##### **Paragraph 4.2.4 is proposed to be amended as:**

4.2.4 If either of the above criteria are not met, then where a department has a formal investment in another public sector entity, it should be reported, following the requirements of IAS 39 (chapter 9).

##### **Paragraph 9.2.7 c) is propose to be amended as:**

9.2.7 The following interpretations of IAS 39 for the public sector context apply.

##### **Recognition**

a) Any financial instrument that is not held in furtherance of the entity's objectives but is held on behalf of government more generally should be accounted for in a separate Trust Statement. Entities should discuss such cases with the relevant authorities.

b) Special or 'golden' shares, being those shares retained in businesses that have been privatised but in which the department wishes to retain a regulatory interest or reserve power, should not be recognised in the statement of financial position.

##### **Measurement**

c) Public Dividend Capital should be reported at historical cost, less any impairment.

#### Effective date of amendments

The effective date for the proposed amendment is 1 April 2011.

## **Update to IAS 39 *Financial Instruments: Recognition and Measurement* and a Summary of IFRS 9 *Financial Instruments***

*This annex provides detail on the latest changes to IAS 39 and a summary of IFRS 9 - it is provided as general explanation to support the exposure draft and is not designed to be a substitute for reading the entire standard and interpretation.*

IAS 39 *Financial Instruments: Recognition and Measurement* was issued by the International Accounting Standards Committee (IASC) in March 1999. There have been a number of revisions to IAS 39 over time, however, wholesale revisions commenced in 2008, mainly in response to the financial crisis and this process has escalated the planned review of the standard. The IASB has planned to complete the revision to IAS 39 by December 2010, when it should be replaced by IFRS 9 in its entirety.

The following are most recent changes to the IAS 39:

- *Eligible Hedged Items* (issued July 2008) - effective date 1 July 2009. This amendment provides clarification on two issues in relation to hedge accounting, identifying inflation as a hedged risk or portion; and hedging with options.
- *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) (issued October 2008) - effective date 1 July 2008. This amendment was in response to calls from constituents, particularly within the European Union, to create a 'level playing field' with US GAAP regarding the ability to reclassify financial assets. The changes to IAS 39 permit an entity to reclassify non-derivative financial assets out of the 'fair value through profit or loss' (FVTPL) and 'available-for-sale' (AFS) categories in limited circumstances. Such reclassifications will trigger additional disclosure requirements.
- *Reclassification of Financial Assets – Effective Date and Transition* (Amendments to IAS 39 and IFRS 7) (issued November 2008). - effective date 1 July 2008. This amendment clarified the effective dates to change above.
- *Embedded Derivatives* -Amendments to IFRIC 9 and IAS 39 (issued March 2009) - effective date 30 June 2009. This amendment clarified the accounting for embedded derivatives when a financial asset is reclassified out of the 'fair value through profit or loss' (FTVPL) category as permitted by the October 2008 amendments to IAS 39 *Financial Instruments: Recognition and Measurement*.

## SUMMARY OF IFRS 9

On 12 November 2009, the IASB issued IFRS 9 *Financial Instruments* as the first step in the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 is a 'work in progress' and will eventually replace IAS 39 in its entirety. The IASB plan to achieve this by 31 December 2010.

IFRS 9 simplifies the mixed measurement model and establishes two primary measurement categories for financial assets, fair value and amortised cost. However the basis for classification will be the entity's business model and the contractual cashflow characteristics of the financial asset.

The IASB intends to expand IFRS 9 during 2010 to add new requirements for classifying and measuring financial liabilities, derecognition of financial instruments, impairment, and hedge accounting, thereby replacing IAS 39 in full.

### **Classification**

IFRS 9 requires that financial assets are classified on initial recognition as measured at amortised cost or fair value and the basis of classification depends on the entity's business model and contractual cashflow characteristics of the financial asset. IAS 39 includes the 'available for sale' and 'held to maturity' categories which are not included in IFRS 9.

### **Measurement**

All financial assets are initially measured at fair value plus, in the case of a financial asset not at fair value through profit or loss (FVTPL), transaction costs.

Subsequent measurement is determined by the original classification, that is amortised cost or fair value.

### **Debt instruments**

A debt instrument that meets the following two conditions can be measured at amortised cost:

- **Business model test.** The objective of the entity's business model is to hold the financial asset to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes).
- **Cash flow characteristics test:** The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

However, there is a Fair value option to designate a financial asset as measured at FVTPL even where the instrument meets the two amortised cost tests. All other debt instruments must be measured at FVTPL.

### **Equity instruments**

All equity investments in scope of IFRS 9 are to be measured at fair value in the balance sheet, with value changes recognised in the equivalent of the profit or loss, except for those equity investments for which the entity has elected to

report value changes in 'Other Comprehensive Expenditure'. There is no 'cost exception' for unquoted equities. However the standard allows that in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to determine fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

#### *Measurement guidance*

Despite the fair value requirement for all equity investments, IFRS 9 contains guidance on when cost may be the best estimate of fair value and also when it might not be representative of fair value.

### **An extract of IFRS 9 guidance is reproduced below:**

*B5.5 All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to determine fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.*

*B5.6 Indicators that cost might not be representative of fair value include:*

- (a) a significant change in the performance of the investee compared with budgets, plans or milestones.*
- (b) changes in expectation that the investee's technical product milestones will be achieved.*
- (c) a significant change in the market for the investee's equity or its products or potential products.*
- (d) a significant change in the global economy or the economic environment in which the investee operates.*
- (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.*
- (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.*
- (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.*

*B5.7 The list in paragraph B5.6 is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must estimate fair value.*

*B5.8 Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).*

### **Derivatives**

All derivatives, including those linked to unquoted equity investments, are measured at fair value. Value changes are recognised in profit or loss unless the

entity has elected to treat the derivative as a hedging instrument in accordance with IAS 39, in which case the requirements of IAS 39 apply.

### **Embedded derivatives**

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host, with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

The embedded derivative concept of IAS 39 is not included in IFRS 9. Consequently, embedded derivatives that under IAS 39 would have been separately accounted for at FVTPL because they were not closely related to the financial host asset will no longer be separated. Instead, the contractual cash flows of the financial asset are assessed in their entirety, and the asset as a whole is measured at FVTPL if any of its cash flows do not represent payments of principal and interest.

### **Reclassification**

For debt instruments, reclassification is required between FVTPL and amortised cost, or vice versa, if and only if the entity's business model objective for its financial assets changes so its previous model assessment would no longer apply.

If reclassification is appropriate, it must be done prospectively from the reclassification date. An entity does not restate any previously recognised gains, losses, or interest.

### **Disclosures**

IFRS 9 amends some of the requirements of IFRS 7 *Financial Instruments: Disclosures* including added disclosures about investments in equity instruments designated as at fair value through the 'other comprehensive expenditure' with only the dividend recognised in profit and loss.

### **Financial Liabilities**

IFRS 9 does not address financial liabilities. The IASB has begun the process of giving further consideration to the classification and measurement of financial liabilities in its project on Credit Risk in Liability Measurement, and it expects to issue final requirements for financial liabilities in 2010.

### **Summary**

The development of IFRS 9 is unlikely to affect the FReM guidance in a fundamental way, however, once the standard is complete and adopted by the EU, a thorough assessment will be undertaken.