Policy choices in IFRS

Purpose of this paper

This paper identifies the various accounting policy choices / elections available in IFRS and considers the bases on which those choices can be exercised and, in some cases, changed.

The purpose of the paper is to draw attention to the different bases for policy choices with a view to stimulating discussion of whether some standardised approach might be relevant or whether different approaches are relevant to different circumstances.

1 Summary of policy choices

1.1 IFRS Standards include various accounting policy choices / elections:

(a) some of which an entity must apply on a transaction-by-transaction basis; and

(b) others which an entity must apply in respect of whole classes of items.

1.2 Of these accounting policy choices / elections:

(a) some must be determined on an irrevocable basis; and

(b) others are subject to change based on satisfying the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

1.3 The following table shows the various types of policy choices and, when relevant, the IASB's basis for providing those choices.

Policy choice	Basis for choice	Transaction or class	Basis for transaction or class	Irrevocable at inception	Basis for irrevocability
Contract to buy or sell a non-financial item [IFRS 9.2.5]	Cost benefit Avoid mismatch	Transaction		Yes	
Equity instruments at FVOCI [IFRS 9.4.1.3]	Not traded	Transaction		Yes	Discipline
Financial asset or liability at FVPL [IFRS 9.4.1.5 & 4.2.2]	Avoid mismatch Reflect evaluation	Transaction		Yes	Discipline, avoid cherry picking
Financial asset when credit risk managed by derivative at FVPL [IFRS 9.6.7.1]	Reflect evaluation	Transaction		No – only for period of derivative	
Financial guarantee contracts [IFRS 17.7(e)]	Works in practice	Transaction		Yes	Possibly IFRS 17.B25[1]
Credit cards or loans with insurance [ED/2019/4.8A]	Cost-benefit	Class		Yes	
PP&E cost or revaluation model [IAS 16.29 & 38]		Class	Avoid selectivity Consistent measure	No – IAS 8	

1 IFRS 17.B25 says: A contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished (ie discharged, cancelled or expired), unless the contract is derecognised applying paragraphs 74–77, because of a contract modification.

Policy choice	Basis for choice	Transaction or class	Basis for transaction or class	Irrevocable at inception	Basis for irrevocability
Intangible assets (in active markets) cost or revaluation model [IAS 38.72 & 73]		Class	Avoid selectivity Consistent measure	No – IAS 8	
Investment property cost or FVPL [IAS 40.30 & 31]		Class		No – IAS 8	
Short term leases = expense [IFRS 16.5 & 8]	Cost-benefit	Class of underlying asset		Effectively	
Low-value leases = expense [IFRS 16.5 & 8]	Cost-benefit	Transaction	Burden of assessing for low value in every lease within a class	Effectively	

2 General factors affecting the basis for policy choices

2.1 Given that a key attribute of useful financial information is its comparability, policy choices should be avoided to the extent feasible.

2.2 Circumstances change and businesses evolve, which tends to support policy choices being revocable.

2.3 The criteria for a policy change under IAS 8 [IAS 8.14] create a 'high hurdle'; but, nevertheless, are judgemental.

2.4 The Conceptual Framework is available to help entities make policy choices [CF.SP1.1(b)].

2.5 Similar assets/liabilities can have different purposes within a business, and some policy choices will be for practical reasons (such as cost versus benefit considerations) which tends to support policy choices being made on a transaction-by-transaction basis.

3 Possible issues

3.1 It could be argued that there should be a greater degree of transparency around the basis on which policy choices are made available in IFRS.

3.2 The reasons for the basis on which policy choices are made available is not always evident. (In some cases, the relevant IFRS pre-dates the era of Bases for Conclusions.) Should there be one or more principles to underpin the basis on which policy choices are made available?

3.3 It may not always be evident as to why some choices are irrevocable and others are not and, instead, rely on IAS 8?

3.4 It might be useful to have some principles to be applied each time it is contemplated to include a policy choice in an IFRS. Some possible principles would be that:

(a) all choices are subject to IAS 8 unless there is a compelling reason to make them irrevocable; and

(b) all choices are applicable to whole classes of items unless there is a compelling reason for them to be on a transaction-by-transaction basis.

3.5 For example, at the IASB's September 2019 meeting,[2] in the context of the comprehensive review of the *IFRS for SMEs*, the Board contemplated the potential for having a policy choice on accounting for borrowing costs (either capitalising in accordance with IAS 23 *Borrowing Costs*

2 September 2019 Agenda reference 30D 'Previous Board decisions – IAS 23 *Borrowing Costs*'.

or expensing all borrowing costs as incurred, as presently required under the *IFRS for SMEs*). The Board decided not to seek views on whether and how to align the *IFRS for SMEs* Standard with IAS 23;[3] however, any further contemplation of such a policy choice should consider whether, and for what reasons, the policy choice is revocable or irrevocable.

4. Irrevocable elections on a transaction-by-transaction basis

IFRS 9 *Financial Instruments*

4.1 IFRS 9 includes conditional irrevocable policy choices – that is, the transactions need to meet specific conditions to be eligible for the policy choice.

Contracts to buy or sell a non-financial item

4.2 IFRS 9.2.5 says (emphasis added):

> 2.5 **A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument, may be irrevocably designated as measured at fair value through profit or loss** even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. **This designation is available only at inception of the contract** and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard (see paragraph 2.4).

4.3 Cost-benefit considerations are the basis for the designation being made available. IFRS 9.BCZ2.35 says (emphasis added):

> BCZ2.35 The IASB considered that the disadvantage of providing an election (ie different accounting outcomes as the result of the entity's choice) by extending the fair value option in IFRS 9 was outweighed by the benefits of this alternative because:
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> (a) it is consistent with the IASB's objective to represent more faithfully the financial position and performance of entities that risk-manage an entire business on a fair value basis;
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> (b) it provides operational relief for entities that risk-manage an entire business on a dynamic fair value basis (ie it is less onerous than applying hedge accounting); and
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> (c) it does not have the unintended consequences of creating an accounting mismatch in some situations.

4.4 IFRS 9.4.1.3 says (emphasis added):

> 4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However **an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income** (see paragraphs 5.7.5–5.7.6).

4.5 The basis for the FVOCI policy choice being irrevocable is to impose discipline. IFRS 9.BC5.25(d) says (emphasis added):

> BC5.25 The concerns expressed in the comment letters were as follows:
>
> (d) *Irrevocability of the exception:* A small number of respondents believed that an entity should be able to reclassify equity instruments into and out of the fair value through other comprehensive income category if an entity starts or ceases to hold the investments for trading purposes. However, **the IASB decided that the option must be irrevocable to provide discipline to its application**. The IASB also noted that the option to designate a financial asset as measured at fair value is also irrevocable.

3 *IASB Update* September 2019.

4.6 IFRS 9.4.1.5 and 4.2.2 say (emphasis added):

> 4.1.5 Despite paragraphs 4.1.1–4.1.4, **an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss** if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32).
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> 4.2.2 **An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss** when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:
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> (a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or
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> (b) 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, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*), for example, the entity's board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36).

4.7 The basis for the FVPL policy choice being irrevocable is to impose discipline and avoid 'cherry picking'. IFRS 9.BCZ4.56 says (emphasis added):

> BCZ4.56 The IASB decided in IAS 39 (as revised in 2003) to permit entities to designate irrevocably on initial recognition any financial instruments as ones to be measured at fair value with gains and losses recognised in profit or loss ('fair value through profit or loss'). **To impose discipline on this approach**, the IASB decided that financial instruments should not be reclassified into or out of the category of fair value through profit or loss. In particular, some comments received on the exposure draft of proposed amendments to IAS 39 published in June 2002 suggested that entities could use the fair value option to recognise selectively changes in fair value in profit or loss. **The IASB noted that the requirement (now in IFRS 9) to designate irrevocably on initial recognition the financial instruments for which the fair value option is to be applied results in an entity being unable to 'cherry pick' in this way.** This is because it will not be known at initial recognition whether the fair value of the instrument will increase or decrease.

IFRS 4 and IFRS 17 *Insurance Contracts*

4.8 IFRS 17.7(e) says [IFRS 4.4(d) says the same] (emphasis added):

> 7 An entity shall not apply IFRS 17 to: …
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> (e) financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. The issuer shall choose to apply either IFRS 17 or IAS 32 *Financial Instruments: Presentation*, IFRS 7 *Financial Instruments: Disclosures* and IFRS 9 *Financial Instruments* to such financial guarantee contracts. **The issuer may make that choice contract by contract, but the choice for each contract is irrevocable**. …

4.9 IFRS 17.BC93 says (emphasis added):

> BC93 …, the Board decided to carry forward to IFRS 17 the option to account for a financial guarantee contract as if it were an insurance contract, without any substantive changes, because **the option has worked in practice and results in consistent accounting for economically similar contracts issued by the same entity**. **The Board did not view it as a high priority to address the inconsistency that results from accounting for financial guarantee contracts differently depending on the issuer**.

5 Irrevocable elections on transition to a new IFRS Standard

5.1 This paper does not address policy choices relating to transactions that are outstanding on transition but which do not apply to subsequent transactions. However, the paper does address policy choices made on transition that have a lasting impact.

ED/2019/4 *Amendments to IFRS 17 Insurance Contracts*

5.2 ED/2019/4.8A proposes (emphasis added):

> 8A **Some contracts meet the definition of an insurance contract but limit the compensation for insured events to the amount required to settle the policyholder's obligation created by the contract (for example, loans with death waivers).** If such contracts are not excluded from the scope of IFRS 17 by paragraphs 7(a)–(h), an entity shall choose to apply IFRS 17 or IFRS 9 to such contracts that it issues. The **entity shall make that choice for each portfolio of insurance contracts, and the choice for each portfolio is irrevocable**.

5.3 Cost-benefit considerations are the main basis for the choice being made available. ED/2019/4.BC19 to BC20 say (emphasis added):

> BC19 Hence, the Board concluded:
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> (a) requiring an entity to apply IFRS 17 to those contracts, when the entity had previously been applying an accounting policy consistent with IFRS 9 or IAS 39 to those contracts (or vice versa), could **impose cost without a corresponding benefit**; and
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> (b) more useful information for users of financial statements might be provided if an entity were to apply the same Standard to those contracts as it applies to other similar contracts it issues.
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> BC20 Accordingly, the Board concluded that, for such contracts, an entity would be required to make the choice between applying IFRS 17 or IFRS 9 for each portfolio of insurance contracts and the choice for each portfolio would be irrevocable.

6. Revocable elections on a transaction-by-transaction basis

IFRS 9 *Financial Instruments*

6.1 IFRS 9.6.7.1 says (emphasis added):

> 6.7.1 If an entity uses a credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or a part of, a financial instrument (credit exposure) it **may designate that financial instrument to the extent that it is so managed (ie all or a proportion of it) as measured at fair value through profit or loss** if:
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> (a) the name of the credit exposure (for example, the borrower, or the holder of a loan commitment) matches the reference entity of the credit derivative ('name matching'); and
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> (b) the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.
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> An entity may make this designation irrespective of whether the financial instrument that is managed for credit risk is within the scope of this Standard (for example, an entity may designate loan commitments that are outside the scope of this Standard). The entity **may designate that financial instrument at, or subsequent to, initial recognition, or while it is unrecognised**. The entity shall document the designation concurrently.

6.2 The basis for the FVPL policy choice is enabling entities to reflect their risk management activity and avoid accounting mismatches. IFRS 9.BCE.213 says (emphasis added):

> BCE.213 The IASB decided to use a **targeted fair value option to reflect the management of credit risk**. The IASB decided to allow the designation of financial instruments, both recognised and unrecognised, to be at fair value through profit or loss if the credit risk of those financial instruments is managed using a credit derivative that is also measured at fair value through profit or loss. This eliminates the accounting mismatch that would otherwise arise from measuring credit derivatives at fair value and hedged items (such as loans) at amortised cost. It also **enables entities to appropriately reflect this risk management activity in their financial statements**. **By allowing entities to make this election also for a proportion of a financial instrument and after its initial recognition, and to subsequently discontinue the fair value measurement for the hedged credit exposure, this approach enables entities to reflect their risk management activity more effectively than using the fair value option (which is available only on initial recognition for the financial instrument in its entirety, and is irrevocable).** This becomes important because entities often do not hedge items for their entire life. This targeted fair value option is

also available for credit exposures that are outside the scope of this Standard, such as most loan commitments.

7. Revocable policy choices on a class-by-class or transaction-by-transaction basis and IAS 8

IAS 16 *Property, Plant and Equipment*

7.1 IAS 16.29 and 38 say (emphasis added):

> 29 An entity shall **choose either the cost model** in paragraph 30 **or the revaluation model** in paragraph 31 as its accounting policy and shall **apply that policy to an entire class of property, plant and equipment**.
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> 38 The items within a class of property, plant and equipment are revalued simultaneously to **avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates**. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

7.2 To change the policy, it would need to meet the criteria in IAS 8.

IAS 38 *Intangible Assets*

7.3 IAS 38.72 and 73 say (emphasis added):

> 72 An entity shall choose either the cost model in paragraph 74 or the revaluation model in paragraph 75 as its accounting policy. **If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model**, unless there is no active market for those assets.
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> 73 A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. The items within a class of intangible assets are revalued simultaneously to **avoid selective revaluation of assets and the reporting of amounts in the financial statements representing a mixture of costs and values as at different dates**.

IAS 40 *Investment Property*

7.4 IAS 16.30 and 31 say (emphasis added):

> 30 With the exception noted in paragraph 32A, an entity shall **choose as its accounting policy either the fair value model** in paragraphs 33–55 **or the cost model** in paragraph 56 and shall **apply that policy to all of its investment property**.
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> 31 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a **voluntary change in accounting policy** shall be made only if the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. **It is highly unlikely that a change from the fair value model to the cost model will result in a more relevant presentation**.

8. Other policy choices on a class-by-class or transaction-by-transaction basis and IAS 8

IFRS 16 *Leases*

8.1 IFRS 16.5 and 8 say (emphasis added):

> 5 A lessee **may elect not to apply the requirements** in paragraphs 22–49 to:
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> (a) ***short-term leases***; and
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> (b) leases for which the ***underlying asset* is of low value** (as described in paragraphs B3–B8).
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> 8 The **election for short-term leases shall be made by class of underlying asset to which the right of use relates**. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. The **election for leases for which the underlying asset is of low value can be made on a lease-by-lease basis**.

8.2 The basis for the policy choices are cost benefit considerations. IFRS 16.BC87, BC98, BC99 and BC103 say (emphasis added):

> BC87 The IASB concluded that the benefits of requiring a lessee to apply all of the requirements in IFRS 16 to short-term leases do not outweigh the associated costs. In considering how to reduce the costs for lessees, the IASB considered both the nature and the scope of a possible exemption.
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> BC98 As noted in paragraph BC84, many lessees expressed concerns about the costs of applying the requirements of IFRS 16 to leases that are large in number but low in value. They suggested that such an exercise would require a significant amount of effort with potentially little effect on reported information.
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> BC99 In the light of these concerns, the IASB decided to provide a recognition exemption for leases of low-value assets. Consequently, IFRS 16 permits a lessee to elect, on a lease-by-lease basis, not to apply the recognition requirements of IFRS 16 to leases for which the underlying asset is of low value.
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> BC103 The IASB decided that the recognition exemption for leases of low-value assets should be applied on a lease-by-lease basis. **A requirement to apply the exemption by class of underlying asset, instead of lease-by-lease, would have introduced a burden on lessees to assess every individual asset within a class**. Consequently, in the IASB's view, the recognition exemption for leases of low-value assets will be easier to apply, and of more benefit to lessees, if applied on a lease-by-lease basis.

9. IAS 8 criteria for policy change

9.1 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* includes criteria for voluntarily changing accounting policies.

> 14 An entity shall change an accounting policy only if the change:
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> (a) is required by an International Financial Reporting Standard; or
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> (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.
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> 29 When a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:
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> (a) the nature of the change in accounting policy;
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> (b) the reasons why applying the new accounting policy provides reliable and more relevant information;
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> (c) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
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> (i) for each financial statement line item affected; and
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> (ii) if IAS 33 applies to the entity, for basic and diluted earnings per share;
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> (d) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
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> (e) if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

~ END ~