LICENSING & GENERAL PURPOSES COMMITTEE

HEAD OF FINANCIAL SERVICES
REPORT NO. FIN1813

9 APRIL 2018

ACCOUNTING STANDARDS ISSUED BUT NOT YET ADOPTED 2017/18

SUMMARY AND RECOMMENDATIONS:

SUMMARY:
This report provides an update on the introduction of International Financial Reporting Standard (IFRS) 9, the new accounting standard relating to financial instruments, including investments that will apply to local authorities for the 2018/19 financial year and onwards.

The application of IFRS9 to local authority accounting has the potential to cause major fluctuations in the Council's net budget requirement. While there is potential for Government to introduce a statutory override, which will negate this effect, consultation on such proposals has yet to be issued. The election proposed in this report, will reduce the overall effect of IFRS9, thereby reducing the scale of fluctuation in the Council's general fund. This protects the Council's position in the event that a statutory override is not granted.

RECOMMENDATION:
That the Licensing and General Purposes Committee approve the irrevocable election to treat its strategic pooled funds as "equity instruments" at fair value through other comprehensive income (FVOCI) on 1 April 2018.

1 INTRODUCTION

1.1 CIPFA/LASAAC[1] approved the adoption of IFRS 9 Financial Instruments into the Local Authority Accounting Code[2] on 8 November 2017 and therefore this will apply to local government accounts from 2018/19. The Board considered the relevance of IFRS 9 to local authority investments and concluded that full adoption of the Standard was appropriate.

1.2 CIPFA/LASAAC[3] approved the adoption of IFRS 9 Financial Instruments into

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[1] CIPFA – Chartered Institute of Public Finance and Accountancy/LASAAC – Local Authority Scotland Accounts Advisory Committee
[2] The Code of Practice on Local Authority Accounting in the United Kingdom issued by CIPFA/LASAAC Local Authority Accounting Code Board on an annual basis
[3] CIPFA – Chartered Institute of Public Finance and Accountancy/LASAAC – Local Authority Scotland Accounts Advisory Committee

the Local Authority Accounting Code[4] on 8 November 2017 and therefore this will apply to local government accounts from 2018/19. The Board considered the relevance of IFRS 9 to local authority investments and concluded that full adoption of the Standard was appropriate.

1.3 All investment activity involves risk and local authorities are required to manage this risk under CIPFA's Treasury Management Code and the statutory Investment Guidance[5]. The Board recognised that local authorities have invested in financial transactions and instruments that contain additional risk to the capital invested. The Board concluded that implementation of IFRS 9 will help to drive improved transparency and decision-making in treasury management and in the determination of longer-term investment strategies.

1.4 One of the key impacts of IFRS9 will be that while many local authority loans and investments will continue to be held at amortised cost, gains and losses arising from changes in the fair value of some categories of investment will have to be recognised in the Council's revenue account. This means that from 2018/19 changes in value of certain investments will have a consequent impact on the general fund. Previously such changes were only recognised in the revenue fund when the asset was sold.

1.5 For example, the Council holds an investment in a property fund, whose capital value has risen over time. Currently this increase in value is held in a reserve and will only be taken to the General Fund when the asset is sold and a gain on the investment is realised. Equally, if the value of the investment were to fall, this would be set against the gains already held in the reserve. The reserve therefore absorbs the fluctuations in value without having an effect on the revenue balances of the Council. Under IFRS9 however, the Council would have to show these gains (or losses) in the revenue account annually as they arise. This could cause major fluctuations in the revenue account, based on unrealised gains and losses, and would directly effect he Council's budget requirement and its funding gap. The Council would need to consider setting aside gains to cover potential future losses therefore influencing the level of reserves the Council sets aside to manage risk.

2 PROPOSAL

2.1 Arlingclose, the Council's Treasury Management advisors, have advised the following action to ensure that movements in the fair value of the Council's strategic pooled fund investments are not taken to the revenue account after the application of IFRS9.

2.2 When first adopting IFRS 9, organisations may irrevocably elect to account for individual investments in "equity instruments" at fair value through other comprehensive income (FVOCI), which is very similar to the current available

[4] The Code of Practice on Local Authority Accounting in the United Kingdom issued by CIPFA/LASAAC Local Authority Accounting Code Board on an annual basis
[5] Guidance on local government investments issued by the Department of Communities and Local government and the Welsh Government

for sale accounting. Investments purchased after the transition to IFRS 9 may also be elected to FVOCI upon acquisition. The definition of an equity instrument is very wide and includes ordinary company shares, some types of preference shares, warrants and units in pooled funds that meet certain conditions. All the long-dated funds held by the Council meet these conditions.

Accounting entries following election

2.3 Where investments have been elected to FVOCI, changes in fair value will be taken to a new Financial Instruments Revaluation Reserve (FIRR). For example, a fall in value would be accounted for as:

Debit Financial Instruments Revaluation Reserve
Credit Long-term investments

The movement in the FIRR will be reported with the Other Comprehensive Income section of the Comprehensive Income and Expenditure Statement (CI&ES).
When the investment is sold, the accumulated gain or loss will be taken direct to the General Fund and reported in the Movement in Reserves Statement (MiRS). Unlike current practice, it is not recycled to the CI&ES.

Debit General Fund
Credit Financial Instruments Revaluation Reserve

Dividends will continue to be recognised as investment income when the authority has the right to receive them, unless they are clearly a repayment of the original investment.

Debit Short-term debtors
Credit Investment income receivable

2.4 There is no requirement in IFRS 9 to assess equity instruments for impairment, irrespective of the election.

2.5 Where pooled funds are classed as capital expenditure, any fair value gains and losses charged to Finance I&E will be reversed out to the Capital Adjustment Account via the MiRS. It might therefore appear that the election to FVOCI is unnecessary. However, since regulations might change in future and the election can only be made on initial recognition or on transition to IFRS 9, the Council should include capital expenditure funds in the election.

Statutory Override

2.6 CIPFA/LASAAC has called for a statutory override so that the introduction of IFRS 9 does not impact on local authorities' revenue accounts. The potential impacts are wider than just strategic pooled funds, and include fair value changes on short-term pooled funds and structured loans and deposits as well the new impairment provisions for all contractual financial assets. Arlingclose supports calls for such an override for these impacts. The clarity provided for strategic pooled funds will also be welcome.

2.7 Gareth Caller of the MHCLG, speaking at CIPFA's Treasury Management Network conference on the 14th March, said the department was planning to consult on statutory overrides to "elements" of IFRS 9, specifically with regard to pooled property investment funds. The consultation going ahead was dependent on the approval of other government departments, which is standard practice for all government consultations. Assuming this was secured, and there was a positive response from consultees, regulations to implement the override would be laid before the end of the next financial year.

2.8 Making the election referred to in paragraph 2.2 however, would provide the Council with some certainty over the treatment of the assets specified in the election and would mitigate the risk that a statutory override may not be implemented.

2.9 This election would be recorded in the disclosure note "Accounting Standards issued But Not Yet Adopted" in the Statement of Accounts for the financial year 2017/18, for each of the council's holdings in strategic bond funds, property funds, equity funds and multi-asset/diversified funds on the 31st March 2018. Each fund will be specifically named in the disclosure.

2.10 A draft of this disclosure note is shown at Appendix 1.

3 CONCLUSION

3.1 Changes to the accounting treatment for Financial Instruments, under IFRS9, could result in a negative impact on council taxpayers, as reserves would have to change to reflect any unrealised losses or gains.

3.2 While a statutory override for some elements of IFRS9 may be implemented in the future, the Council should protect its general fund from the potential for significant fluctuations by making an irrevocable election from 1st April 2018 to account for its strategic pooled funds as equity instruments at fair value through other comprehensive income.

BACKGROUND INFORMATION
http://www.cipfa.org/policy-and-guidance/consultations-archive/201718-code-of-practice-on-local-authority-accounting-in-the-united-kingdom-invitation-to-comment

http://www.cipfa.org/policy-and-guidance/publications/c/code-of-practice-on-local-authority-accounting-in-the-united-kingdom-201718-book

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DRAFT DISCLOSURE NOTE TO BE INCLUDED IN THE 2017/18 STATEMENT OF ACCOUNTS

Accounting Standards Issued but not yet Adopted

IFRS 9 Financial Instruments
The Council will adopt IFRS 9 Financial Instruments with effect from 1st April 2018. The main changes include the reclassification of financial assets and the earlier recognition of the impairment of financial assets.

The Council does not expect the reclassification changes to have a material impact upon the financial statements because the majority of its financial assets will retain the same measurement basis. To this end, on 1st April 2018 the Council irrevocably elected to present changes in the fair value of the following equity investments in other comprehensive income as permitted by the IFRS:

- M &G Strategic Corporate Bond Fund
- Payden Absolute Bond Fund
- CCLA LAMIT Property Fund
- UBS Multi Asset Income Fund
- Threadneedle UK Equity income Fund

The Council does not expect the impairment changes to have a material impact upon the financial statements because the impairment charge will be immaterial for its treasury management assets (e.g. bank deposits and bonds) and it already makes a provision for doubtful debts on its service assets (e.g. trade receivables).

The estimated additional provision to be made as at 1st April 2018 is £XXX.