MODULE 7

Financial Instruments

A INTRODUCTION

Please see the following section of the Code

Section 7.1

A1 Chapter seven of the Code is wholly concerned with accounting for financial instruments. The provisions provide a comprehensive approach to all the instruments that an authority might issue or acquire.

A2 The Code's accounting requirements derive from the following International Financial Reporting and Accounting Standards.

- IAS 39 *Financial Instruments: Recognition and Measurement*
- IAS 32 *Financial Instruments: Presentation*
- IFRS 7 *Financial Instruments: Disclosures*

except where adaptations to fit the public sector are set out in the Code. IPSAS 28, IPSAS 29 and IPSAS 30 provide additional guidance for the public sector.

A3 These IFRS and IAS are very long and complex as they are designed to encompass the full range of sophisticated financial instruments that are used in the commercial world to manage financial risks and speculate on future financial conditions. The Code has been drafted so that it will be unnecessary for authorities to make reference to them in accounting for the instruments that they commonly hold. However, the Code does not cover in detail the financial instruments held exceptionally by local authorities and the techniques covered by hedge accounting. Where instruments are held or where circumstances arise that are not covered by the Code, the IFRS or IAS will need to be consulted.

A4 Paragraph 7.1.1.1 of the Code notes that the 2007 SORP adopted the UK GAAP version of the financial instruments standards. The UK standards are converged with the international standards. It would therefore be inappropriate to use the international standards' transitional provisions in relation to financial instruments on adopting international standards in the Code. However, the Code notes that where they continue to be relevant the transitional provisions of the UK standards adopted by the 2007 SORP remain.

A5 This will apply in particular to recognition and derecognition decisions prior to 1 April 2006 that should not be reconsidered. For instance, the accounting policies for premiums and discounts incurred and financial guarantees entered into before 1 April 2006 may not

be consistent with the Code's current requirements. Care will be needed to explain these inconsistencies in the accounting policies where they have a material effect.

Practical Implications

A6 Practitioners should not regard the Code requirements as merely a technical accounting exercise. They have the potential to have a far-reaching impact, including the better presentation of value, gains and losses than shown by cash flows, the greater detail needed in supporting accounting records, and having a substantial influence on the authority's treasury management practices. The particular issues to which practitioners will need to have regard are:

- **Influence over treasury management practices** – such things as the need to account for transactions with a clear focus on their substance rather than their contractual form, requirements to assess the fair value of financial instruments and the disclosures to be made about risk exposure might provide new information that an authority has not effectively taken into account in its strategies for borrowing and investments. It is beyond the scope of these Guidance Notes to advise on how strategies might change, but the accounting guidance that follows should be discussed with the authority's treasury experts.
- **Impact on council tax** – several of the treatments required by the Code involve either:
  - the making of debits and credits to the Comprehensive Income and Expenditure Statement that do not reflect cash transactions; for example, the recognition of losses incurred when making soft loans or giving financial guarantees, or
  - the scheduling of debits and credits to the Comprehensive Income and Expenditure Statement differently from those set out in contracts; for example, interest on loans with stepped rates might need to be accounted for on the basis of a single effective interest rate applying over the loan's term.

  Practitioners will need to be aware of these potential impacts on the Comprehensive Income and Expenditure Statement and understand the statutory arrangements applicable in each territory that might allow the charge to the Comprehensive Income and Expenditure Statement to be adjusted for in the Movement in Reserves Statement so that the impact on council tax can be managed effectively (see paragraphs B18, B22 and C11 of this module for details of the statutory provisions).
- **Underlying accounting records** – many of the accounting requirements operate on the basis of fair value and amortised cost rather than the cash flows that will take place under the contract. Depending upon the sorts of instruments that the authority holds, there may be a significant need to extend the working papers that are maintained in relation to borrowings and investments. Records will be needed of effective interest rate and amortised cost calculations, schedules for debits and credits for interest expense and interest income, fair value assessments and the reconciling adjustments planned in the Movement in Reserves Statement. These memorandum records will potentially need to be kept securely for 50 years or more where authorities have instruments with long lives.
- **Impact on investment managers** – where an authority's investments are managed on their behalf by managers acting as agents for the authority, then the accounting requirements will need to be applied to the portfolio held by the managers as if it were

held by the authority. Authorities will need to discuss with investment managers the accounting status of managed funds (in particular whether they are trading for short-term gains) and the information that will be needed for accounts preparation, particularly to ensure that accounting treatments do not compromise prudent stewardship of the funds.

- **Need for expertise** – while most borrowings and investments can be accounted for straightforwardly under the arrangements, there will be occasions (such as the assessment of fair values) when complicated calculations might be necessary, potentially requiring expert knowledge of market conditions. Authorities will need to ensure that expert assistance is available to them whenever it might be required for the preparation of the Statement of Accounts.

What are Financial Instruments?

A7 Financial instruments are formally defined in paragraph 7.1.2.1 of the Code as contracts that give rise to a financial asset of one entity and a financial liability or equity instrument of another entity. For local authorities, which do not issue equity instruments such as share capital, this means the following.

Financial asset	A right to future economic benefits controlled by the authority that is represented by: ■ cash ■ an equity instrument of another entity ■ a contractual right to receive cash (or another financial asset) from another entity ■ a contractual right to exchange financial assets/liabilities with another entity under conditions that are potentially favourable to the authority.
Financial liability	An obligation to transfer economic benefits controlled by the authority that is represented by: ■ a contractual obligation to deliver cash (or another financial asset) to another entity ■ a contractual obligation to exchange financial assets/liabilities with another entity under conditions that are potentially unfavourable to the authority.
Equity instrument	A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities (such as an equity share in a company) – this will only apply to investments in other entities held by the authority.

A8 The definition is broad and will cover the instruments used in the treasury management activity of an authority, including the borrowing and lending of money and the making of investments. However, it also extends to include such things as receivables and payables and financial guarantees. At the other extreme are a number of complex arrangements: derivatives (swaps, forwards, options, etc) and embedded derivatives (derivatives hosted within a wider contract). Embedded derivatives that might be encountered by local authorities, and which might need to be accounted for separately, include PFI[1] deals where an element of the unitary payment varies in accordance with an underlying measure (such as RPI plus a percentage) and fuel contracts which include a multiplier based on an underlying price index. The derivative elements might need to be accounted for separately because

1. These are referred to in the Code as service concession arrangements but are commonly known as Private Finance Initiative (PFI) schemes.

the increase is not based on a relevant index, but a multiplier of a relevant index. Where the increase is based on a relevant index (such as RPI in the PFI example above), the derivative is likely to be closely related to the host contract and will not need to be accounted for separately.

Exemptions from the Definition

A9 Some rights and obligations that would otherwise be financial instruments are excluded from the requirements of chapter seven of the Code as they are covered by more specific provisions about their recognition, measurement and disclosure (paragraph 7.1.2.2 of the Code):

- Interests in subsidiaries, associates and joint ventures (provided that the entities are included within the authority's group accounts); such interests are to be carried separately from financial instruments in the Balance Sheet at cost (less any provision for losses) or fair value.
- Rights and obligations arising from leases and PFI, PPP and similar schemes, except for:
  - lessors' lease receivables in relation to the derecognition and impairment provisions of chapter seven of the Code
  - lessees' lease payables in relation to derecognition provisions and derivatives that are embedded into any lease arrangement
  - payables under PFI, PPP and similar schemes with respect to the derecognition provisions, and
  - derivatives that are embedded in leases and PFI, PPP and similar schemes.

  (The Code notes that the disclosure requirements of chapter seven of the Code apply in full to these transactions and balances.)
- Employers' rights and obligations under employee benefit plans.
- Loan commitments, unless they can be settled net or there is a past practice of selling the resulting loans shortly after origination or the commitment is to provide at below market interest rate. (However, all loan commitments are subject to the derecognition provisions of chapter seven of the Code). Loan commitments not within the scope of chapter seven (and IAS 39) will (where onerous) be accounted for in accordance with the Code and IAS 37 (see paragraphs 66 to 69 of IAS 37).
- Contracts to buy or sell non-financial items (eg commodity futures contracts) are outside the scope of chapter seven unless they can be settled net and are not entered into and held for the purposes of the receipt or delivery of a non-financial item in accordance with the authority's expected purchase, sale or usage requirements.
- Financial instrument contracts and obligations under share-based transactions (those that are settled by the transfer of equity instruments) to which paragraph A.1.6 of Appendix A of the Code applies.
- Rights and obligations arising under an insurance contract as defined in IFRS 4 *Insurance Contracts* other than a financial guarantee contract that meets the definition of a financial guarantee contract under paragraphs 7.2.4.1 to 7.2.4.4 of the Code (see paragraphs B27 and B36 of this module).

- Rights to receive reimbursement of expenditure required to be made to settle a liability recognised as a provision in accordance with section 8.2 of the Code, or for which in an earlier period was recognised as a provision.
- Forward contracts between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date (see chapter nine of the Code).

Amounts relating to such things as council tax, non-domestic rates, general rates, etc are outside the scope of the accounting provisions as they are statutory debts and do not arise from contracts.

Framework for Accounting for Financial Instruments

A10 There are several stages in the process of accounting for financial instruments, as follows.

Initial recognition	Financial assets and liabilities will need to be brought on to the Balance Sheet when the authority becomes a party to contractual provisions. This will often be the date that a contract is entered into, but may be later if there are conditions that need to be satisfied.
Initial measurement	When assets and liabilities are recognised, they also need to be measured at their fair value. The most common situation is that the appropriate measure will be the originating transaction (eg the principal amount of a loan or the price paid for buying an investment), but this might not be the case where there have been substantial transaction costs, interest payable or receivable does not reflect market rates or obligations have been taken on under financial guarantees.
Amortisation	Some assets and liabilities will be carried at 'amortised cost' where part of their carrying amount in the Balance Sheet will either be written down or written up via the Surplus or Deficit on the Provision of Services over the term of the instrument. Amortisation reflects such things as the fact that an authority might have incurred transaction costs, bought an investment other than at par or been able to defer interest payments and is required to spread the effect over the life of the instrument.
Valuation	For the purposes of notes to the accounts, all assets and liabilities will need to be given a fair value, although this will only be recorded in the Balance Sheet for 'available-for-sale' assets or assets held as at 'fair value through profit or loss'. For many instruments fair value will be the same as the outstanding principal amount, but for others there could be a substantial difference (eg borrowing at fixed interest rates or an investment in shares).
Impairment	Financial assets may need to be written down for impairment losses, where it becomes probable that payments due under a contract will not be made.
Derecognition	Financial assets and liabilities will need to be removed from the Balance Sheet once performance under the contract is complete or the contract is terminated.

There might also be other events in the lifecycle of a financial instrument, such as changing underlying market conditions, default, renegotiation, etc that could influence Balance Sheet and Comprehensive Income and Expenditure Statement treatments.

Initial Recognition of Financial Assets and Liabilities

A11 The date of initial recognition of financial instruments is usually straightforward. As instruments rely on a contract being in place, recognition takes place when the holder of an instrument becomes a party to its contractual provisions and thus takes on contractual rights or obligations that meet the standard accounting definition of assets or liabilities. This will not necessarily be the date that a contract is entered into if conditions remain to be satisfied before the authority takes on a legal right or a legal obligation to pay. The process might also be different from the way in which ordinary debtors and creditors would normally be recognised in the course of local government business. Such 'trade receivables' and 'trade payables' would be recognised only once goods have been received or services supplied. However, for some other financial instruments it may be necessary to recognise the instrument before any transfer of economic benefits actually takes place between the parties to the contract, since under some arrangements potential future cash flows can have a current value.

A12 Paragraphs 7.1.3.1 to 7.1.3.3 of the Code specify the following treatments:

- **Financial assets and derivatives** – for an instrument acquired by the authority, the 'trade date' should be used, ie the date on which the purchaser of the instrument becomes committed to the purchase and would not be able to avoid acquiring it without breaking the contract, rather than the date that settlement will actually take place (if later).
- **Financial liabilities** – unless the contract is a derivative, liabilities are recognised when the other party has met a commitment under the contract that creates an obligation for the authority to transfer economic benefits. For instance, when an authority takes out a loan, the advance of cash from the lender initiates the obligation to repay at some future date, and the loan would be recognised as a liability on the Balance Sheet when the advance is received.

A13 More complicated recognition issues will arise where an authority enters into derivative contracts (agreements such as forward rate transactions, futures and swaps that transfer the financial risk inherent in an underlying financial instrument). A precursor to entering into such instruments is that the authority determines that it has both the legal powers to enter into such contracts and the expertise to manage the contract effectively. Such contracts will normally have no value at the time the contract is entered into, as there will be a presumption of 'status quo' as to how variables relating to the contract might change. But as the underlying measure (such as interest rates, inflation or the fair value of an underlying financial instrument) changes, the derivative will become either an asset or a liability in advance of the settlement date. For these contracts, recognition will practicably be required when the initial zero fair value changes and an asset or liability arises (see paragraphs A32 to A57 of this module.)

A14 IAS 39 gives a 'regular way' exemption in relation to certain transactions where there is a gap between trade date and settlement date but this is a normal timeframe for the marketplace. For instance, an entity might under normal administrative rules contract to purchase shares on the stock exchange in advance of the shares actually being delivered to the purchaser. Such transactions are allowed by IAS 39 to be recognised on their trade date, so as to avoid having to account for a derivative for the time between this date and the settlement

date. Paragraph 7.1.3.5 of the Code has adopted this option and does not allow authorities to adopt the alternative settlement date basis for accounting. The Code requires that the *trade date* rather than the *settlement date* is used to recognise the regular way purchase or sale of a financial asset. There is unlikely to be any material difference in any case for the instruments taken out by local authorities, but this clears up absolutely any issues about derivative accounting in these cases.

Initial Measurement of Financial Instruments

A15 Paragraph 7.1.4.1 of the Code specifies that **all** financial instruments (whether assets or liabilities) should be recognised on the basis of fair value adjusted for transaction costs* that are directly attributable to the acquisition or issue of a financial asset or liability:

- **Fair value –** this is defined in paragraph 7.1.4.2 of the Code as the amount for which an asset could be exchanged or a liability settled, assuming that the transaction was negotiated between parties knowledgeable about the market in which they are dealing and willing to buy/sell at an appropriate price, with no other motive in their negotiations other than to secure a fair price. In most cases, this amount will be the transaction price, eg the amount of a loan made or the price paid for a bond. The relatively common situations in which local authorities undertake transactions other than at arm's length are the making of loans at less than prevailing market rates, known as soft loans, and the receipt of loans at concessionary rates. The implications of these loans are discussed in paragraphs A17 to A28.

Adjusted for:

- **Transaction costs that are directly attributable to the acquisition/issue of the instrument** – paragraph 7.1.4.1 of the Code specifies that costs will include fees and commissions paid to agents, advisers, brokers and dealers; levies by regulatory agencies and securities exchanges; and transfer taxes and duties. A wider definition would cover all incremental costs that are directly attributable to the acquisition/issue/disposal of an instrument, with incremental costs being those that would not have been incurred if the transaction had not taken place. Internal administrative costs are excluded from this definition because they are not usually incremental – employee costs and overheads will normally be incurred whether or not particular transactions are concluded.

** These principles do not apply to instruments classified as 'at fair value through profit or loss', where transaction costs are expensed immediately.*

A16 For most of the transactions entered into by a local authority, transactions costs might be negligible and could be ignored as immaterial. For example, the PWLB charges an administration fee when advancing new loans, but at the current rates of 35p and 45p per £1,000 advanced for fixed and variable rate loans respectively this is not likely to be material for an authority's accounts. However, there might be cases where significant fees are involved, eg where investments are managed by an agent or where an authority prepares for a stock issue. Where there are transaction costs, the accounting process will be:

- **Financial asset** – transaction costs are added to the fair value of the asset. The addition is taken into account in the calculation of the effective interest rate. The effective interest rate will thus be lower than the contracted coupon, leading to a lower credit to the

Comprehensive Income and Expenditure Statement than the interest actually receivable in the year. The difference between the credit to the Comprehensive Income and Expenditure Statement and the interest receivable will be posted to the asset in the Balance Sheet, effectively amortising the transaction costs over the life of the instrument.

- **Financial liability** – transaction costs are deducted from the fair value of the liability and taken into account in the calculation of amortised cost and the effective interest rate. The effective interest rate will thus be higher than the contracted coupon, leading to a higher charge to the Comprehensive Income and Expenditure Statement than the interest actually payable in the year. The difference between the Comprehensive Income and Expenditure Statement charge and the interest payable will be posted to the liability in the Balance Sheet, effectively amortising the transaction costs over the life of the instrument.

Soft Loans Advanced

A17 Authorities will sometimes make loans at less than market rates, where a service objective would justify the authority making a concession. Examples include loans to lower-tier authorities and voluntary organisations (to facilitate the authority's own responsibilities for service provision), to local businesses (to encourage economic development), or to employees (perhaps as part of a relocation package). Paragraph 7.1.4.3 of the Code requires the discounted interest rate to be recognised as a reduction in the fair value of the asset when measured for the first time.

A18 The treatment reflects the economic substance of the transaction, ie the authority is locking itself into an arrangement where it will incur an effective loss on interest receivable over the life of the instrument. This loss will be anticipated by calculating the present value of all future cash receipts using the prevailing market interest rate for a similar instrument taken out by an organisation with a similar credit rating. This will result in a lower figure for fair value than the amount advanced, the difference being required to be debited to the Comprehensive Income and Expenditure Statement as service expenditure on grants to mark the loss at the date of the advance. The debit should be made against the relevant service revenue account(s) that is deemed to benefit from the advance being made. This will normally be the service approving the advance, but it is possible for an authority to identify other services that will gain from the benefits generated.

ILLUSTRATION: MAKING A SOFT LOAN

Troybolton District Council makes a £100,000 loan to the Wildcats Basketball Association for the building of new sporting facilities. The loan is made on 1 April 20XX and repayable on maturity in three years' time. Interest is to be charged one year in arrears at 3%, but the council assesses that an unsubsidised rate for such a loan would have been 6%.

Calculation of initial fair value

The initial fair value of the loan is calculated by scheduling the cash flows due to take place over the life of the loan (after the advance has been made) and discounting them to present value using the unsubsidised rate of interest:

	Cash Flows £	Discount Factor £	Present Value £
Advance	100,000		
Year 1	(3,000)	0.94340	(2,830)
Year 2	(3,000)	0.89000	(2,670)
Year 3	(103,000)	0.83962	(86,481)
			(91,981)

A19 The subsequent treatment that paragraph 7.1.4.4 of the Code specifies for soft loans is:

- the credit to the Comprehensive Income and Expenditure Statement each year for interest receivable will be based on the higher effective interest rate
- the matching entries will be an amount for the actual interest receivable for the year (debited to cash or debtors) and the difference between the interest credited to the Comprehensive Income and Expenditure Statement and the actual interest receivable (debited to the loan in the Balance Sheet, to write the carrying amount up to its full value by the repayment date).

ILLUSTRATION: ACCOUNTING FOR A SOFT LOAN

Taking the example in paragraph A18, the making of the loan would be accounted for by:

Dr Long Term Debtors £91,981
Cr Cash £100,000
Dr Comprehensive Income and Expenditure Statement – relevant service revenue account(s) £8,019

Interest will then be credited and the amortised cost written up according to the following schedule:

	Amortised Cost at 1 April £	Surplus or Deficit on the Provision of Services Interest Credit* £	Cash Payments £	Amortised Cost at 31 March £
	A	B	C	A+B–C
Year 1	(91,981)	(5,519)	3,000	(94,500)
Year 2	(94,500)	(5,670)	3,000	(97,170)
Year 3	(97,170)	(5,830)	3,000	(100,000)

* based on the amortised cost at 1 April multiplied by 6%

In Year 1, the accounts entries will be:

Dr Cash £3,000
Dr Loans and Receivables £2,519
Cr Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure £5,519

A20 De minimis principles can be applied to soft loans. For the purposes of the Statement of Accounts, it might not be necessary to apply the detailed accounting treatment where only a low value of such advances have been made and/or there has not been significant discounting of interest rates. However, even if an authority decides that it would be immaterial to account fully for losses on soft loans, the amount of the effective subsidisation of the borrower will still be useful management information at the time the advance is being considered.

A21 There are a number of complications relating to soft loans:

- **The interest rate against which to calculate fair value** – in calculating the fair value on initial measurement, an estimate of the prevailing rate of interest needs to be made. The estimate will depend on both market conditions at the date of the advance and the credit rating of the borrower. This should be an important part of the decision to make a soft loan, as it will indicate clearly to decision makers the amount by which the borrower will be subsidised over the life of the loan and allow an assessment of the reasonableness of the abatement of interest.

  Paragraph 7.1.4.5 of the Code states that the rate chosen should be one that is appropriate to the borrower, but such a rate would be different depending on whether appropriateness is judged from the viewpoint of the borrower (the rate at which they would be able to borrow in the market) or of the authority as a lender (the authority's cost of borrowing plus any risk premium relevant to the borrower). The Code encourages the latter view – it suggests that a rate might be arrived at by taking the authority's prevailing cost of borrowing (or average investment rate) and adding an allowance for the risk that the loan might not be repaid by the particular lender (the credit risk). This cost of borrowing should be based on the marginal rate of interest, rather than any average measure of interest payable on the overall loan portfolio.

- **Charges over property** – where authorities voluntarily allow clients to defer payment for services by rolling up costs against a legal charge on the client's property, this charge may represent a soft loan where interest is charged at a concessionary rate. Where the charge is on a percentage of the value of the property, rather than a fixed amount, this will raise issues as to whether the arrangement includes a separable embedded derivative represented by the potential gain or loss that will be attributable to movements in house prices (see paragraph A52 of this module).
  - Where a legal charge is raised against a client's property as a method of recovering debt this does not amount to a soft loan if the authority is required to make the charge statutorily (eg under section 22 of the Health and Social Services and Social Security Adjudications Act 1983). Such amounts should be accounted for as a debtor. Where the charge is made voluntarily (eg under section 55 of the 1983 Act), there may be a soft loan.
  - In working out the soft loan impact, the nature of the charges means that it will be difficult to estimate the life of the loan on an individual basis. The write-down to fair value of the loans could therefore be estimated on a portfolio basis. To assess the loans as a portfolio, authorities will need to estimate the average length of their arrangements, based on past experience. The average remaining life of the loans can be assumed to be half that of the average life of the arrangements; this will allow for

the fact that some arrangements will be nearing their end whilst others will have just started. The calculation will need to be revisited at each Balance Sheet date.

- **Loans to subsidiaries** – where a soft loan is made to a company or other entity that is a subsidiary for group accounts purposes, the 'loss' represented by the undercharge of interest will remain in the authority's group. The authority is effectively making an additional investment in the subsidiary. Paragraph 7.1.4.9 of the Code therefore requires in these circumstances that the 'loss' on the initial measurement of the loan should not be debited to the Comprehensive Income and Expenditure Statement but posted to the Balance Sheet as an additional investment in the subsidiary. Over the life of the loan, the Comprehensive Income and Expenditure Statement will be credited with the contracted interest receivable for the year, with the difference between that amount and the market rate (as assessed in the first bullet point above) being used to write down the investment. Using the same figures as per the example in paragraph A19:

  Dr Loans and Receivables £91,981
  Dr Investments £8,019
  Cr Cash £100,000
  Making the loan

  Dr Cash £3,000
  Cr Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure £3,000
  Dr Loans and Receivables £2,519
  Cr Investments £2,519
  Transactions for Year 1 (eg)

- **Effecting the statutory provisions that limit the impact of the loss on the General Fund Balance** – statutory provisions relating to the accounting for financial instruments are discussed in paragraphs B18, B22 and C11 of this module. In England and Wales, the amendments to the relevant Capital Finance Regulations also cover soft loans advanced from 2007/08 and subsequent years. They require authorities to reverse the impact on the General Fund Balance of accounting for soft loans in the Comprehensive Income and Expenditure Statement in accordance with the Code, such that the General Fund is credited with the actual interest receivable (if any) under the loan agreement. The entries based on the effective interest rate made in the Comprehensive Income and Expenditure Statement per the Code requirements are reversed out and replaced by the actual interest receivable, posting the balancing entry to the Financial Instruments Adjustment Account. Following the credit of £5,519 to the Comprehensive Income and Expenditure Statement per the entries in paragraph A19, the charge to the General Fund Balance needs to be reduced to £3,000:

  Dr Financial Instruments Adjustment Account £8,019
  Cr General Fund Balance (in the Movement in Reserves Statement) £8,019
  Reversing out the loss debited on recognition

  Dr General Fund Balance (in the Movement in Reserves Statement) £2,519
  Cr Financial Instruments Adjustment Account £2,519
  Reversing out the additional interest credit (eg) in Year 1

A22 The statutory guidance for Scotland does not allow authorities to make adjustments to the Comprehensive Income and Expenditure Statement entries for loans made after 1 April 2007. There are no relevant provisions in Northern Ireland.

Loans Taken Out at Concessionary Rates

A23 There may be occasions when an authority is in receipt of loans that are interest free or at less than prevailing market rates. If material, the effective interest rate of these loans will need to be calculated so that the value of the financial assistance provided to the authority by the lender can be separated from the financing cost of the transaction. (Note that this treatment should not be applied to PWLB loans – although they might have marginally lower than market interest rates, this reflects the ability of the government itself to borrow cheaply, not a subsidisation of local government.)

A24 The treatment reflects the economic substance of the transaction; the authority is being provided with a loan on advantageous terms that will allow it to make a greater amount of capital investment than would otherwise be the case. The gain represented by this opportunity will be anticipated by working out the present value of all future cash payments using the prevailing borrowing rate for a similar loan taken out by the authority. This will result in a lower figure for the fair value of the loan than the amount received, the difference being expected to be accounted for as a government grant (or other contribution). The Code in paragraph 2.3.2.16 anticipates that, in the majority of cases, the loan will be for the acquisition or enhancement of an asset and as such the benefit is accounted for in accordance with section 2.3 of the Code's provisions on capital grants (or other capital contributions), ie recognised as a gain in the Comprehensive Income and Expenditure Statement when conditions have been satisfied. However, authorities should also refer to paragraph C15 in Module 2 of these Guidance Notes for further assistance in this area.

A25 The gain would need to be reversed out in the Movement in Reserves Statement to the Financial Instruments Adjustments Account (as this is a transaction generated by differences between legislation and the application of the Code's financial instruments accounting provisions).

A26 The subsequent accounting treatment for the loan will be:

- the debit to the Comprehensive Income and Expenditure Statement each year for interest payable will be based on the higher effective interest rate
- the difference between the interest debited to the Comprehensive Income and Expenditure Statement and the actual interest payable (if any) under the loan agreement will be reversed out to the Financial Instruments Adjustment Account and reported in the Movement in Reserves Statement.

A27 De minimis principles can be applied to loans at concessionary rates. The accounting transactions detailed in paragraph A26 will generate a credit(s) to the Comprehensive Income and Expenditure Statement to reflect the benefit gained from the effective financial assistance (see also paragraph C15 in Module 2 of these Guidance Notes). If this is a material benefit, then it might be necessary to adopt the detailed accounting treatment for the loan/ financial assistance.

A28 In accounting for concessionary loans, authorities will need to determine the effective interest rate against which to calculate the fair value of the loan made to them. If the loan that the authority receives has similar terms to loans offered by the PWLB, then that rate should be used except where the authority can provide reliable evidence that it would be able to borrow at a lower rate from another lender at arm's length terms. Where there is no comparable PWLB loan, the authority will need to make an estimate of what a market rate would be, taking into account the authority's credit status.

Classification of Financial Instruments

A29 Although all financial instruments are required to be measured initially on the basis of fair value, subsequent measurement depends on the classifications of an instrument – the mixed measurement model. IAS 39 defines two classes of financial liabilities and four classes of financial assets, each of which has its own measurement basis and requirements for recognising gains and losses.

Classification	Underlying principles	Treatment in the Code
Financial Liabilities		
1. Amortised cost	This category contains all of an authority's financial liabilities that are not 'held for trading' or derivatives. Examples include operational creditors and borrowings. These liabilities are carried at amortised cost. The Comprehensive Income and Expenditure Statement is charged with interest payable.	The Code recognises this category of liabilities.
2. Fair value through profit and loss	This classification is used for liabilities held for trading or derivatives with a negative value. Under IAS 39, an entity can also choose to designate a financial liability as at fair value through profit and loss that would not by definition be required to be so classified, but the Code does not permit this. The distinctive treatment of such liabilities would be that all gains and losses are posted to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement when they arise.	Local authorities are not expected to take on liabilities for the purpose of trading in them, but the Code recognises that there might be exceptional instances when authorities hold liabilities that qualify for this treatment.
Financial Assets		
1. Loans and receivables	These are defined as financial assets (excluding derivatives) that have fixed or determinate payments and that are not quoted in an active market, other than: a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, or b) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.	The Code recognises this category of assets.

Classification	Underlying principles	Treatment in the Code
1. Loans and receivables (continued)	Examples include operational debtors and bank deposits. Loans and receivables are carried at amortised cost. The Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement is charged with interest receivable, impairment losses and any gain or loss on 'derecognition' (ie disposal or maturity). Movements in fair value during the life of the asset are not recognised.	
2. Available for sale	Available-for-sale assets are defined as those non-derivative financial assets that are not classified as a) loans and receivables, b) held-to-maturity investments or c) financial assets at fair value through profit or loss. This category contains items that do not fit under any of the other financial asset categories. Examples include equity shareholdings and quoted investments. Available-for-sale assets are carried at their fair value; movements in fair value are posted to a revaluation reserve (the Available for Sale Financial Instruments Reserve) and taken to the Surplus or Deficit on Revaluation of Available-for-Sale Financial Assets line in the Comprehensive Income and Expenditure Statement. Interest and dividends income are also charged to the Surplus or Deficit on the Provision of Services alongside gains/losses on derecognition in the Comprehensive Income and Expenditure Statement.	The Code recognises this category of assets.
3. Fair value through profit and loss	This designation is used for assets that are held for trading and for derivatives with a positive value. Under IAS 39 an entity can also choose to designate a financial asset as at fair value through profit and loss that would not by definition be required to be so classified, but the Code does not permit this. The distinctive treatment of such assets would be that all gains and losses are posted to the Surplus or Deficit on the Provision of Services when they arise.	Local authorities are not expected to hold investments purely for the purpose of trading in them, but the Code recognises that there might be some instances when authorities hold assets that are required to be included in this category. The commonest area where this might apply is external investment funds.
4. Held to maturity	This is a discretionary category that entities can use to designate financial assets that have fixed or determinable payments and a fixed maturity. The entity has to intend to accept the instrument's stipulated contractual cash flows and be indifferent to possible changes in fair value (and have no recent history (within the last two years) of selling any other held-to-maturity assets).	This is an entirely discretionary category of financial asset and the Code has prohibited its use so that all authorities account consistently for financial assets.

A30 These considerations mean that the great majority of financial instruments held by local authorities would fall into one of three categories defined in IAS 39. Financial liabilities will generally be 'amortised cost'; financial assets will be either 'loans and receivables' or 'available for sale'.

A31 Occasionally, authorities might acquire instruments that fall within the 'fair value through profit and loss' classification (eg a forward rate transaction or investments held as a portfolio). The Code identifies the forward purchase of investments as an example, which would be required to be accounted for as derivatives between the trade and settlement date.

Financial Assets and Liabilities at Fair Value through Profit or Loss

A32 IAS 39 details a separate class of financial instruments that is described as 'held for trading' and is accounted for on the basis of 'fair value through profit or loss'. These instruments will be held in the hope that they will be remunerative, but an adverse movement against market expectations could result in losses being incurred. Instruments can therefore be either assets or liabilities, depending on the prevailing trading position.

A33 The definition of 'held for trading' covers three types of transaction, as follows.

Instruments acquired or incurred principally for the purpose of selling or repurchasing them in the near term	The Code confirms that there has to be a speculative motive behind trading, with an intention to generate a profit from fluctuations in the price of an instrument or the dealer's margin. The fact that instruments are being bought and sold is not sufficient if this is done as part of the active stewardship of an authority's surplus funds. Assessment will need to be made against an authority's own circumstances surrounding its objectives for buying and selling activity, rather than on the contractual terms of a particular instrument. Authorities have generally been disinclined to regard treasury management as a speculative activity, leading to low expectations that instruments will be held that fall into this category.
Instruments that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking	This is a subsidiary category that draws in other instruments that might not have been categorised as 'held for trading' if considered individually. All instruments that are part of a group of financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking are brought within the definition. The main significance of a financial instrument being part of a portfolio is that if it is concluded that some financial instruments within the portfolio are being held for trading, all the instruments within the portfolio shall be classified as held for trading. An example would be the appointment of external fund managers to administer a proportion of the authority's cash holdings, with instructions that permit short-term profit taking.

Derivatives	All derivatives are classified as 'held for trading', irrespective of the entity's view as to why it has acquired or incurred the instrument. Derivatives are defined in IAS 39 as instruments with all of the following three characteristics: ■ their value changes in response to changes in an 'underlying' – a specified interest rate, financial instrument price, credit rating, etc ■ they require no initial net investment (they are instruments concerned with conditional future cash flows or transfers of instruments that have a nil fair value on entry into the contract), or have a smaller initial net investment than would be required for other types of contract that would be expected to have a similar response to changes in market factors (eg the payment of a risk premium to secure an option on the future purchase of a financial instrument) ■ settlement will take place at a future date. The primary purpose of a derivative is to create rights and obligations that have the effect of transferring financial risks inherent in an underlying financial instrument. Consequently, derivatives can be used to generate profits from risk transfer or as hedging devices for managing risks.

A34 The most common scenario where a 'fair value through profit or loss' would normally be appropriate would be where investments are held as part of a portfolio and managed on the basis of the overall fair value of the portfolio. Under IAS 39, a commercial entity would be able to designate such a portfolio as 'fair value through profit and loss' and account for the overall movement on the portfolio over the year in the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement, whether or not gains/losses had been realised by 31 March.

A35 The 'fair value through profit or loss' accounting treatment would closely parallel the way in which local authorities have habitually managed portfolios held by fund managers. However, the Code closes off all the designatory routes that are available under IAS 39. Authorities wishing to align the accounting treatment and their management practice will need to follow the mandatory route specified in the second row of the analysis in the table in paragraph A33.

A36 The mandatory route requires evidence of a recent actual pattern of short-term profit taking. It is not usually considered sufficient for the portfolio manager to have made gains by selling investments before their maturity date; the investments have to have been purchased with this intention. This sort of speculative activity is not one that authorities would be expected routinely to be involved with. However, the accounting rules only require a pattern of activity within the portfolio, not a material balance of such transactions.

A37 Whether a portfolio meets the definition is likely to depend on the instructions given to the fund manager. If the fund manager has instructions to buy and sell investments purely to balance risk, then it is likely that the portfolio will not meet the profit-taking criterion. Where instructions allow managers to trade in investments on the authority's behalf, it is good treasury management practice to ensure that this does not expose the authority to an unreasonable risk of loss. The outcome of even a minor pattern of profit taking would in these circumstances then require 'fair value through profit or loss' treatment.

A38 Where an authority cannot demonstrate an actual pattern of short-term profit taking, the portfolio will need to be disaggregated and accounted for as individual investments.

Derivatives

A39 The following table illustrates the most common forms of derivative found in the commercial world.

Derivative	Underlying	Notional Amount	Settlement Amount
Stock options	Market price of share	Number of shares	(Market price at settlement – strike price) x number of shares
Currency forward	Currency rate	Number of currency units	(Spot rate at settlement – forward rate) x number of currency units
Commodity future	Commodity price per unit	Number of commodity units	Net settlement occurs daily and is determined by the change in the futures price and discounted to reflect the time to maturity
Interest rate swap	Interest rate index (eg receive 5% fixed and pay LIBOR)	Amounts in currency units	Net settlement occurs periodically throughout the contract's term based on the formula: (current interest rate index – fixed rate specified in the contract) x amounts in currency units
Fixed payment contract – a commitment to make a payment if a specified event takes place	For example, six-month LIBOR increases by 100 points	Not specified	Settlement amount based on payment provision in the contract

A40 Historically, the greatest volume of local authority involvement in derivatives has been with interest rate swaps. This involvement was determined by the courts to be unlawful, and many authorities have taken a prudent view that the same principles will apply to other speculative transactions. The legal framework was enhanced in England and Wales by the powers in section 12 of the Local Government Act 2003 for authorities to invest for the purposes of the prudent management of their financial affairs. For English authorities the Localism Act 2011 introduced the General Power of Competence which allows local authorities to do anything an individual can do unless specifically prohibited by law. There is as yet no weight of influential opinion that these or any other powers definitively support the use of derivatives.

A41 Paragraph 7.1.6.4 of the Code identifies forward purchase contracts as the likeliest form of derivatives that authorities might currently hold. These are agreements to buy an investment at a specified price at a specified date. When the contract is entered into (the trade date), the expectation would be that the forward price will be the fair value of the investment at

the settlement date, and the derivative would itself have a fair value of zero. However, if the fair value of the investment changes in the intervening period, the forward purchase contract will become an asset (rise in value of the underlying investment) or a liability (fall in value of the underlying investment). The difference between the fair value on the settlement date and consideration paid under the forward contract (ie the gain or loss on the forward contract derivative) is recognised in the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement.

A42 If a forward contract is open at the year-end, the gain or loss on the forward contract is charged to the Surplus or Deficit on the Provision of Services. If the forward contact has a positive value it is shown as a financial asset in the Balance Sheet. If it has a negative value it is shown as a financial liability in the Balance Sheet.

Accounting for Financial Assets and Liabilities at Fair Value through Profit or Loss

A43 The Code does not set out any accounting requirements but refers authorities to the appropriate IFRS where they hold significant amounts of instruments that need to be accounted for at fair value through profit or loss. The relevant provisions are contained in IAS 39 and the basic requirements can be stated relatively simply:

- the instrument will be recognised at its fair value, which might be nil
- the instrument will then be carried at its fair value
- movements in fair value recorded in the Balance Sheet will be balanced by posting gains and losses to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement as they arise
- any residual gains and losses arising at the settlement date will be cleared through the Surplus or Deficit on the Provision of Services.

A44 The principles are thus straightforward. However, greater problems are likely to arise in practice in determining the fair value of an instrument, particularly if the authority holds a complex derivative with more than one underlying. The task is made simpler by the general prohibition on forecasting future changes in market conditions. For instance, the fair value of a forward purchase contract will be calculated by comparing the forward price to the comparative market price of the underlying at the Balance Sheet date.

Embedded Derivatives

A45 Although authorities might not hold any instruments that can be identified as derivatives, it is possible that they might have embedded derivatives. These arise where there are terms and conditions of a wider contract (the host contract) that behave like a free-standing derivative. Their objective will be to change the nature of cash flows that would otherwise be required by the host contract and effectively shift financial risks between the parties to the host contract. Embedded derivatives might thus arise inadvertently through market practices and common contractual arrangements, such as leases and insurance agreements.

A46 The Code identifies one example of an embedded derivative relating to financial instruments, ie the lender/borrower options in LOBO loans. Further examples are provided in section C of the implementation guidance of IAS 39. Any contract entered into by an authority could

potentially have a derivative embedded in it. For example, all contracts other than short-term agreements are likely to have terms in them for the adjustment of prices for inflation that will make reference to such things as the Retail Prices Index and industry-specific indices.

A47 Accounting complications will arise where an embedded derivative is required to be separated from its host contract and accounted for as fair value through profit or loss. There are specific criteria that have to be met for this to be the case:

- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (eg provisions for price increases in a service contract are to be based on an index that does not reasonably reflect how the cost of the service is likely to change)
- a separate instrument with the same terms would meet the definition of a derivative (see paragraph A33)
- the host contract is not already being accounted for as fair value through profit or loss.

A48 The first of the provisions in the preceding paragraph is likely to mean that most embedded derivatives that an authority has entered into will not need to be separated. For the same reasons that authorities have avoided entering directly into derivatives, there will be a reluctance to agree to terms in a wider contract that are not related to its economic characteristics and risks. The Code sets out that lender/borrower options in LOBOs would not normally be required to be separately accounted for under IAS 39. Similarly, provisions for price increases in service contracts will usually be agreed using measures that will reasonably approximate changes in the actual costs of providing the service.

A49 The Code adopts IFRIC 9 *Reassessment of Embedded Derivatives* and therefore authorities need to assess whether an embedded derivative must be separated from the host contract and accounted for separately as a derivative when the authority first becomes a party to the contract. Subsequent reassessment is prohibited by the Code unless there is either:

- a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, or
- a reclassification of a financial asset out of the fair value through profit or loss category,

in which cases a reassessment is required. IFRIC 9 sets out that an authority would determine whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows in the contract.

A50 Once an assessment has been made as to whether or not an embedded derivative needs to be separated, the accounting process will be:

- where there is separation – the embedded derivative will be accounted for as if it were a standalone derivative, with the host contract being accounted for as if the terms and conditions represented by the embedded derivative were not included
- where there is no separation – the host contract will be accounted for in terms of its overall status, with the potential changes in variables relating to the embedded derivative being taken into account in the assessment of fair values and amortised cost as appropriate to the financial instrument, in the same way as for other variable aspects of the contract.

Practical Consideration of Embedded Derivatives

A51 Embedded derivatives are commonplace in local government. Any contract that contains terms that will alter the cash flows that might take place dependent on movements in an underlying variable will have embedded derivatives hosted within it. However, it will be much rarer for embedded derivatives to require separation, as such terms will generally have been negotiated on the basis of best estimating how cash flows should change as the price of inputs to a service change or the quality of services provided improves or worsens.

A52 Generally, embedded derivatives are potentially separable in the following circumstances:

- the provisions in the contract have the potential to lead to a material change in the cash flows that will take place at any point over the contract's term
- the variable against which the variations in the cash flows is to be calculated is not a reasonable measure of the changes in costs, quantities or qualities that might occur under the contract.

A53 Authorities could be expected to ensure that all the terms of a contract are closely related to the goods and/or services that will be procured under a contract. Unless an authority has deliberately sought to hedge risks to which they might otherwise have been exposed or to attempt to defer payments to the later stages of a contract, experience in other sectors suggests that the likeliest circumstance in which separation might be necessary would be where the authority has accepted a contractor's standard terms of business without identifying terms that are not closely related.

A54 Authorities with PFI agreements are probably at the greatest risk of having separable embedded derivatives. However, the following terms are likely to be 'closely related' (provided that they are not leveraged, ie brought into the calculations using a multiple or a fraction, such as 1.1 times RPI):

- increases in unitary payments related to an index such as RPI and there is no reason to suppose that RPI will not be a fair measure of relevant price increases
- increases or reductions in charges due to varying levels of demand or reductions in charges due to poor performance: these changes are matched to the risks contained in the overall contract
- variations in interest charges – where these are related to the underlying debt within the contract (for example, changes in interest that arise as part of a refinancing exercise).

A55 Possibilities of embedded derivatives also exist where an authority has agreed that a debt can be settled by reference to some future transaction and is dependent on the amount then raised. For instance, a charge might be put on a property with the authority due to receive a percentage of the value of the property when it is sold or the debtor dies. The amount then due will be dependent on fluctuations in the value of the property that might have no necessary link to the original debt. In such cases, consideration will be given to accounting separately for the original debt and the gain/loss that might arise from movements in the value of the property.

A56 Authorities will need to carry out at minimum an annual review to confirm that they have no separable embedded derivatives. This is unlikely to require a clause-by-clause review of

all the contracts held by the authority, but the amount of work required will differ between authorities. The review will need to bring together:

- an understanding of what constitutes a financial guarantee or an embedded derivative and the typical circumstances in which they might arise

with:

- relevant knowledge of the terms of contractual arrangements entered into by the authority

in a systematic way that:

- identifies the main areas of risk for material transactions and provides assurance about them.

A57 At smaller authorities, this could be achieved by discussions with a single contracts officer, but at larger authorities consultation with officers in other departments might be needed.

Hedge Accounting

A58 Hedging is the process of entering into a derivative contract with a counterparty in the expectation that the transaction will eliminate or reduce exposure to a particular risk, such as movements in interest rates. Risk reduction is obtained because the derivative's value or cash flows are expected to move in the opposite direction to changes in the value or cash flows of the hedged item.

A59 There is little evidence that authorities use hedging techniques, because of doubts about the legal powers to enter into such contracts. Where hedging is used, the Code permits hedge accounting to be applied, but relies on practitioners to make direct reference to the provisions in IAS 39 (as adopted by the European Union) for the accounting treatment and IAS 32 and IFRS 7 for presentation and disclosure requirements.

A60 The purpose of hedge accounting is to change the usual accounting treatment of a hedging instrument or a hedged item to enable the gains and losses for both the hedging instrument and the hedged item to be recognised in the same period, the aim being to reduce significant distortions because of gains/losses. IAS 39 only allows hedge accounting where the hedging relationship is designated and formally recorded at inception and for as long as the hedge remains 'highly effective'.

A61 IAS 39 does not make hedge accounting mandatory where hedging relationships have been entered into and entities can account for assets and liabilities separately. Authorities are only likely to opt for hedge accounting where separate accounting will result in an imbalance of gains and losses across financial years that introduces volatility that would have a substantial impact on council tax.

A62 The Code notes that it is unlikely that an authority will be involved in hedges of a net investment in a foreign operation, but if they are the authority is required to apply IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* (per paragraph 7.1.7.3 of the Code).

B ACCOUNTING FOR FINANCIAL LIABILITIES AFTER INITIAL RECOGNITION

Please see the following section of the Code

Section 7.2

B1 Apart from exceptional transactions that would fall to be treated as 'fair value through profit and loss' (see paragraphs A32 to A57 of this module), financial liabilities are accounted for using the amortised cost model. The model requires an authority to account for a financial liability by applying a calculated single effective interest rate (EIR) over the expected life of the instrument, rather than posting the cash flows contractually designated as 'interest' (however described), thus reflecting the underlying economic substance of the gains/losses accruing under the instrument. The pattern of these gains/losses may be substantially different from the contractually specified cash flows (eg a loan with stepped interest). The model has the following features.

Financial Liabilities – Amortised Cost	
Measurement basis for the Balance Sheet	The liability is maintained in the Balance Sheet at amortised cost: ■ Initial measurement will be at fair value – normally the amount of the originating transaction, such as the receipt of a loan advance – less transaction costs. ■ The effective interest rate is then calculated – the rate of interest that will discount the estimated cash flows that will take place over the life of the instrument (principal and interest) to the amount in the Balance Sheet at initial measurement. ■ This results in a Balance Sheet carrying amount (the amortised cost) and a profile of interest charges that might be different from the amounts specified in the contract as being for interest and principal. However, for most liabilities, such as loans at fixed interest or at variable rates linked to base rates, and without significant transaction costs, the two should be the same. ■ The amortised costs in the Balance Sheet then change as: – Interest based on the amortised cost for the year is charged to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement (see below). – Cash is paid to the lender (for either principal or interest). – For example, if the charge to the Comprehensive Income and Expenditure Statement for the year is £100,000 but the authority has paid £70,000 for principal and £110,000 for interest that year, the amortised cost in the Balance Sheet will reduce by £80,000 (100 – (70 + 110)). – There are no revaluations to fair value at any point in the instrument's life once it has been measured initially.

Financial Liabilities – Amortised Cost	
Accounting for gains and losses	All gains and losses are recognised in the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement: ■ Financing costs, calculated by applying the effective interest rate to the amortised cost for the year, are debited to Surplus or Deficit on the Provision of Services. ■ Any gains and losses that arise when the liability is derecognised (eg because a premium becomes payable on early redemption) are debited or credited to Surplus or Deficit on the Provision of Services.

Amortised Cost using the Effective Interest Rate

B2 Amortised cost is a mechanism that sees through contractual terms to measure the real cost that an authority bears each year from entering into a financial liability. For instance, if a premium is paid for the right to enter into a loan at less than market rates or a period of lower than market interest rates is granted and compensated for by a period of higher than market rates, authorities are required to account using a single effective interest rate. Interest payable in the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement will then be recognised on a level interest rate basis over the expected life of the loan.

B3 The effective interest rate is the rate of interest that will discount all the cash flows that will take place throughout the expected life of a financial instrument down to the fair value of the asset calculated at initial measurement. The cash flows included in the calculation will cover both interest and principal, plus any other consideration that the authority is scheduled to give or receive during the instrument's life, however described in the contract. The concept is best appreciated through a worked example; see overleaf.

ILLUSTRATION: CALCULATION OF AMORTISED COST

Tomblibooze District Council takes out a simple stepped loan of £1m, to be repaid in full at the end of the fifth year. For the first two years, interest is payable at 2%, rising by one-and-a-half percentage points in each of the final three years. In setting up this loan agreement, the council paid £30,000 in advisers' fees. There are no lenders' or borrowers' options to vary the terms of the loan at any point.

Calculation of effective interest rate (EIR)

The EIR is calculated by establishing the discount rate that will reduce the expected cash flows to fair value of the loan at initial recognition, net of transaction costs (ie £970,000). The cash flows under the example loan are as follows:

	Principal	Interest	Total	Discount Factor	Present Value*
	£	£	£		£
Year 1	–	20,000	20,000	0.958048	19,161
Year 2	–	20,000	20,000	0.917857	18,357
Year 3	–	35,000	35,000	0.879351	30,777
Year 4	–	50,000	50,000	0.842461	42,123
Year 5	1,000,000	65,000	1,065,000	0.807118	859,582
			1,190,000		970,000

* The effective interest rate for the loan is 4.37886% – the rate that reduces the cash flows that will take place over the life of the loan down to its amortised cost of £970,000 at initial measurement; the £1m advanced, less the £30,000 transaction costs. The netting down is done to provide a basis for spreading the transaction cost debited to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement over the life of the loan.

Calculation of amortised cost and the Surplus or Deficit on the Provision of Services charges over the life of the loan

	Carrying Amount b/f	Surplus or Deficit on the Provision of Services Interest Payable @ 4.37886%	Cash Outflows	Carrying Amount c/f*
	£	£	£	£
	A	B	C	D
		(A x 4.37886%)		(A + B – C)
Year 1 start	–	–	–	970,000
Year 1 end	970,000	42,475	20,000	992,475
Year 2 end	992,475	43,459	20,000	1,015,934
Year 3 end	1,015,934	44,486	35,000	1,025,420
Year 4 end	1,025,420	44,902	50,000	1,020,322
Year 5 end	1,020,322	44,678	1,065,000	0

* The carrying amount at the end of the year is calculated by taking the amortised cost at the start of the year, deducting the actual value of the cash outflows taking place in the year and adding the interest cost charged for the year to the Surplus or Deficit on the Provision of Services.

This will be reflected in the following accounting entries (using Year 1 figures as an example):

Dr	Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure	£42,475
Cr	Cash	£20,000
Cr	Loans Outstanding	£22,475

B4 There are several elements of the example that require further discussion:

- Although the example features a loan that is repayable on maturity, the model works in exactly the same way for equal instalments of principal or annuity loans. The only difference will be that cash flows for principal repayments on which the calculations are based will be spread over the life of the instrument rather than left until maturity.
- The discounting of the interest payable by the authority has been carried out as if the interest was paid at 31 March each year. This has been done to make the example more straightforward to follow. In practical terms, the assumption might also produce a materially acceptable effective interest rate. However, where cash flows take place over the course of each year, the discounting will be more accurate if it is carried out using a quarterly or monthly analysis.
- If the transaction costs of £30,000 were judged to be immaterial, they could be written off immediately to the Surplus or Deficit on the Provision of Services. They have been included here to show how transaction costs that are deducted from the initial fair value of the loan are absorbed into the overall process for charging the Surplus or Deficit on the Provision of Services. The effective interest rate contains an element that over the life of the instrument will generate debits to the Surplus or Deficit on the Provision of Services equal to the transaction costs as part of the overall interest charge. Authorities will need to determine their own de minimis limits for transaction costs that ensure they comply with the Code in all material respects.

B5 For many of the loans taken out in local government, it will not be necessary to carry out a formal calculation of the effective interest rate, as any calculation will confirm the interest rate in the contract as the effective rate. This will be the case where:

- The liability has no interest charges, but is for a short duration, such that any benefit arising from not being charged interest is insignificant. (The materiality of any prospective losses will depend on a combination of the amount outstanding, the period for which credit is being granted and prevailing rates. There is thus no prescribed definition of 'short duration'.)
- The liability has interest chargeable at a fixed rate (with no scheduled variations), no premiums or discounts have been included in the initial measurement of the liability, and there are no transaction costs that have been added – NB: where there have been such additions/subtractions made against the amount of the loan advanced, the effective interest rate will need to be calculated to ensure that the effect of these adjustments is amortised properly over the life of the liability.

- The liability has a variable interest rate but no changes in rate are anticipated when the loan is taken out (not because there will not be changes, but because they are too uncertain to be predicted – see paragraph B7), and no premiums, discounts or transaction costs are included in the initial measurement of the liability.

B6 Where an authority deducts transaction costs from the liability when it is measured initially, an effective interest rate calculation will be required, to ensure that the additional costs are amortised properly over the life of the instrument. Otherwise, the costs will be left on the Balance Sheet unfinanced. Paragraph 7.2.2.6 of the Code encourages authorities to consider the materiality of transaction costs and to apply a de minimis below which they are written off immediately to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement.

Variable Rate Financial Instruments

B7 There are two main types of financial instrument under which interest payable might vary over the instrument's life:

- Those where interest is programmed to vary in accordance with an underlying measure that reflects the cost of borrowing (such as LIBOR) – as variations in interest rates cannot be predicted, these loans are accounted for as fixed interest, until the rate actually changes. At this point, the loan will be reassessed against the new schedule of cash flows that will now take place over the remaining term and a new amortisation schedule established. However, if there are no significant additional costs that have been added to the fair value on initial measurement, the new amortisation schedule should be the same as the new amounts of interest payable under the contract.
- Those where the variation in the interest payable is programmed at the start of the contract (such as a stepped interest loan) – as these variations can be predicted, they should be programmed into the calculation of the effective interest rate, which will then spread the incidence of interest more fairly across the life of the liability.
- Other types of liability that might have variable payments, such as those where there is an option to charge a higher rate of interest that might or might not be exercised (eg certain types of LOBOs) or where variations might be linked to a variable that does not reflect the cost of borrowing (eg a derivative) are discussed in greater detail in section A of this module.

Expected Life and Cash Flows of a Financial Instrument

B8 The calculation of the effective interest rate and amortised cost at initial measurement is required to be carried out using estimates of the cash flows and the life of an instrument. Authorities are required to make their best assessment of what these might be at the time that a liability is taken on and to make any necessary adjustments when these estimates need to be revised.

B9 This process has the following features:

- All the contractual terms should be considered, including any for early repayment and other options.

- Where there are options in a contract, these would have been assessed for a separate treatment as embedded derivatives when the contract was taken out. In most cases in local government, the embedded derivative will be closely related to the debt host and not accounted for separately. Where the option is accounted for separately as an embedded derivative, it is not taken into account in the estimation of cash flows, which are then scheduled on the basis that the option is not available. For example, if the embedded derivative relates to early repayment, the effective interest rate would have been calculated on the basis that the instrument will be held for its full term.
- Where there are uncertainties as to future economic conditions that cannot reasonably be predicted (the most obvious example being future interest rates), then changes in these conditions should not be programmed into projections of cash flows until they become likely. In many cases, such as changes in interest rates, this will not be until they actually occur.
- Authorities may have experience of particular instruments that will allow them to estimate that the instrument will have a shorter term than that in the contract. For local government, the most reasonable assumption is that an instrument will be held for its full term unless the authority has a specified intention to repay/call in early or reliable experience of similar instruments being derecognised before the full term.
- It is important that best estimates are made at the initial measurement because the effective interest rate of an instrument is not changed once it has been calculated. Where estimates change, the initial effective interest rate is used to assess the impact rather than itself being recalculated. (An exception is made for instruments accounted for under hedging accounting requirements (see paragraph A58 to A62 of this module), where a revised effective interest rate is used (see also IAS 39, paragraphs 92 and AG8).)
- When estimated cash flows change, the impact is assessed by discounting these new cash flows at the original effective interest rate. Where this results in a difference between the new amortised cost and the carrying amount in the Balance Sheet, this gain or loss is taken to the Surplus or Deficit on the Provision of Services.

Derecognition of a Financial Liability

B10 Derecognition is the stage at which a financial liability is removed from the Balance Sheet – the point at which obligations under the contract are discharged, cancelled or expire. This will usually be the date that an authority settles its liabilities to the creditor, eg by repaying a loan.

B11 It is becoming more common for authorities to have debt repaid on their behalf. For instance, where an authority transfers housing stock and the net proceeds are less than the PWLB loans the authority is deemed to have outstanding in relation to capital investment in that stock, the government will pay these loans off on behalf of the authority and finance any premiums payable. These loans will be derecognised at the point at which the PWLB releases the authority from its contractual obligations.

B12 The consideration paid to extinguish a liability will normally equal its carrying amount. Even where charges to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement have not been based on contractual cash flows but on

the effective interest rate, the calculations will usually ensure that the amortised cost of the liability at the end of the contract is the principal repayable. If there is a difference between the carrying amount of the extinguished financial liability and the consideration paid to extinguish it, this difference will be debited or credited to the Surplus or Deficit on the Provision of Services.

B13 In local government, differences most commonly arise when loans are repaid early and premiums become payable or discounts become receivable. These circumstances are discussed in greater detail in paragraphs B18 to B21. The following example illustrates the treatment of a gain arising from the cancellation of a loan.

ILLUSTRATION: TREATMENT OF A GAIN ARISING FROM THE CANCELLATION OF A LOAN

The government agrees to provide financial assistance to Ninn Keenonk Council for a new capital scheme by writing off a loan of £1m that was due to be repaid in five years' time.

The loan will be derecognised in the Balance Sheet. The matching credit for the capital grant will be made to the Taxation and Non-specific Grant Income and Expenditure line in the Comprehensive Income and Expenditure Statement to show the benefit secured by the authority in having its obligations cancelled.

Because the credit is effectively a grant towards the capital financing of assets that have now been disposed of, it will be reversed out to the Capital Adjustment Account in the Movement in Reserves Statement (see Module 2 for the treatment of capital grants).

This example presumes that no premiums were due on the early repayment of these loans. Where they are (or discounts were receivable), these additional amounts would also need to be debited/credited to the Surplus or Deficit on the Provision of Services.

Restructuring of Existing Debt

B14 The most common example in local government of a liability being derecognised at a gain or loss is upon the early repayment of loans. Generally, paragraph 7.2.3.2 of the Code now requires authorities to post premiums and discounts in full to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement when they become payable. However, it is possible that premiums and discounts could be part of a wider restructuring of a loan portfolio that results in a new portfolio with substantially the same terms. If this is the case, the restructuring would be accounted for as a modification of the original liabilities. The requirements for such a scenario are:

- The premium/discount arises as old debt is replaced by new debt with the same lender or the terms of an existing instrument are modified.
- The terms of the exchange or the modification do not result in substantial differences from the old terms. This is defined formally in paragraph 7.2.3.4 of the Code as being the case where the present value of the net cash flows under the new/modified loan is within 10% of the present value of the cash flows programmed over the remaining life of the original liability (ie between 90% and 110%). The present value is required to be calculated using effective interest rate of the original liability.
- Where there has been an exchange of loan instruments, paragraph 7.2.3.3 of the Code requires the exchange to be simultaneous (ie on the same day) – restructurings will not

apply if there is a time gap between the end of the original contract and the start of the new one that extends beyond one day. The Code notes that net settlement is not required as long as any payments between lender and borrower are made on the same day.

B15 Under extant PWLB rules, authorities are unable formally to exchange loans. An exchange therefore has to be effected practically by repaying the old loan and taking out a new loan, with cash flowing from and to the authority. The Code's requirements mean that a transaction will qualify as an exchange where an authority starts and finishes the day as the borrower of loans with substantially the same terms. This brings restructuring involving the PWLB within the scope of provisions relating to exchanges.

B16 The assessment as to whether there has been an exchange or a modification whereby the projected cash flows before and after the restructuring are scheduled out according to when payment is due and then discounted using the original effective interest rate (NB: the example shows the premium being formally wrapped up in the new loan, but other restructurings will feature an up-front payment) is best understood by way of a worked example.

ILLUSTRATION: ASSESSMENT OF DEBT RESTRUCTURING EXERCISE

Plynne Keyplonque Council had taken out a loan of £1m at a fixed rate of 8% that has four years to run. Interest rates have fallen. The lender offers to cancel the existing loan agreement provided that the council agrees to take out a replacement loan of £1.2m at 6% for eight years (the £0.2m representing a premium charged on the restructuring). An immaterial amount of arrangement fees was payable.

At the date of the restructuring, the projected cash flows for the original loan were as follows, the contracted interest rate of 8% also being the effective interest rate for the loan:

	Principal	Interest	Total	Discount Factor	Present Value
	£	£	£		£
Year 1	–	80,000	80,000	0.92592593	74,074
Year 2	–	80,000	80,000	0.85733882	68,587
Year 3	–	80,000	80,000	0.79383224	63,507
Year 4	1,000,000	80,000	1,080,000	0.73502985	793,832
			1,320,000		1,000,000

The calculation confirms that the amortised cost of the loan at the restructuring date is equal to the principal amount in the contract.

Under the new agreement to borrow £1.2m at 6%, the scheduled cash flows (discounted at the original rate of interest of 8%) are as follows:

	Principal	Interest	Total	Discount Factor	Present Value
	£	£	£		£
Year 1	–	72,000	72,000	0.92592593	66,667
Year 2	–	72,000	72,000	0.85733882	61,728
Year 3	–	72,000	72,000	0.79383224	57,156
Year 4	–	72,000	72,000	0.73502985	52,922
Year 5	–	72,000	72,000	0.6805832	49,002
Year 6	–	72,000	72,000	0.63016963	45,372
Year 7	–	72,000	72,000	0.5834904	42,011
Year 8	1,200,000	72,000	1,272,000	0.54026888	687,222
			1,776,000		1,062,081

As the present value of the new cash flows of £1,062,081 is only 6.21% more than the £1,000,000 amortised cost, the restructuring qualifies under the 10% rule as an exchange of instruments.

B17 The special accounting treatment for modifications and exchanges is that the premium or discount is not posted to Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement but adjusts the carrying amount of the liability. It is then amortised over the life of the modified contract or new instrument. In order to achieve this, the effective interest rate is recalculated. If this were not done, the carrying amount of the new loan would not be amortised down to the principal repayment amount at the end of the contract.

ILLUSTRATION: RECALCULATION OF EFFECTIVE INTEREST RATE

For the exchange of instruments in paragraph B16, an effective interest rate of 9.01% following the restructuring is calculated as follows:

	Premium and Principal £	Interest £	Total £	Discount Factor	Present Value* £
Year 1	–	72,000	72,000	0.9173247	66,047
Year 2	–	72,000	72,000	0.8414846	60,587
Year 3	–	72,000	72,000	0.7719146	55,578
Year 4	–	72,000	72,000	0.7080963	57,031
Year 5	–	72,000	72,000	0.6495542	46,768
Year 6	–	72,000	72,000	0.5958521	42,901
Year 7	–	72,000	72,000	0.5465898	39,354
Year 8	1,200,000	72,000	1,272,000	0.5014003	637,781
			1,776,000		1,000,000

* The effective interest rate for the loan is the rate that reduces the cash flows that will take place over the life of the modified/new loan down to its amortised cost of £1,000,000 at initial measurement (9.01%). The initial amortised cost is the amount of the replacement loan (£1,200,000) less the adjustment for the premium paid (£200,000). As this is a loan exchange, the £200,000 premium was settled not by paying the lender cash but via the agreement to a new loan of £1,200,000 in exchange for a replaced loan with an amortised cost of £1,000,000. Since the loan exchange passed the 10% test, the loss represented by accepting a larger liability can be used to adjust the carrying amount (amortised cost) of the replacement loan. If the 10% test had been failed, the replacement loan would have been carried at £1,200,000 and the £200,000 loss incurred by accepting a larger loan in the exchange would be charged immediately to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement.

Regulations and Statutory Guidance on Premiums and Discounts

B18 The accounting treatment for premiums and discounts arising on the early repayment of loans is largely dictated by the general principle that financial instruments are derecognised when the contracts that establish them come to an end. Apart from the circumstances relating to modification or exchange mentioned in the preceding paragraphs, premiums and discounts will arise from the extinguishment of a financial liability. The amounts payable or receivable will thus be required to be cleared to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement upon extinguishment.

B19 However, it has been recognised by government that this accounting treatment does not necessarily result in a charge that is equitable in terms of the impact of gains and losses on council tax payers. Provisions have therefore been introduced that allow authorities to spread the impact of premiums and discounts on council tax over future financial years (and in England and Wales actually require this for discounts).

	England	Wales	Scotland
Source of provisions	**The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2007 (SI 2007/573)**	**The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2007 (SI 2007/1051 (W.108))**	**Statutory Guidance issued under section 12(2)(b) of the Local Government in Scotland Act 2003 on 30 March 2007 as Finance Circular 4/2007**
Premiums and discounts remaining on the Balance Sheet at 31 March 2007	Where transition at 1 April 2007 reduces the carrying amount of premiums and discounts, annual revenue charges should at least equal the 1 April 2007 balance spread over the longer of the unexpired term of the repaid or replacement loans (premiums) or the longer of the unexpired term of the repaid loan or by 31 March 2016 (discounts). A higher amount can be written down if the authority so determines (premiums only).	Where transition at 1 April 2007 reduces the carrying amount of premiums and discounts, annual revenue charges should at least equal the 1 April 2007 balance spread over the longer of the unexpired term of the repaid or replacement loans (premiums) or the longer of the unexpired term of the repaid loan or by 31 March 2016 (discounts). A higher amount can be written down if the authority so determines (premiums only).	Annual debits and credits to continue to be made against the General Fund Balance in accordance with a schedule detailing all premiums/ discounts carried on the Balance Sheet for 31 March 2007 and their profiled debits and credits, prepared in accordance with pre-2007/08 practices. Higher annual charges than those scheduled are permitted. Protection applies to overhanging premiums, even if they become overhanging after 1 April 2007.

	England	Wales	Scotland
Premiums and discounts incurred after 1 April 2007	Where premiums are incurred that are not required to be accounted for as an adjustment to the carrying amount of a replacement loan, premiums may be spread over the longer of the outstanding term on the replaced loan or the term of the replacement loans. Authorities are able to choose a shorter period. Where discounts are received that are not required to be accounted for as an adjustment to the carrying amount of a replacement loan, discounts must be spread over a minimum period equal to the outstanding term on the replaced loan or 10 years (if shorter).	Where premiums are incurred that are not required to be accounted for as an adjustment to the carrying amount of a replacement loan, premiums may be spread over the longer of the outstanding term on the replaced loan or the term of the replacement loans. Authorities are able to choose a shorter period. Where discounts are received that are not required to be accounted for as an adjustment to the carrying amount of a replacement loan, discounts must be spread over a minimum period equal to the outstanding term on the replaced loan or 10 years (if shorter).	Where the premium/discount arises as a result of refinancing and the replacement loan is fixed interest, debits/credits may be spread over the life of the replacement loan. Where the replacement loan has a variable interest rate, debits/credits may be spread over the life of the replacement loan, up to a maximum of 20 years. Where there are no replacement loans, the maximum write-off period is five years. If a replacement loan supporting the amortisation of a premium/discount is itself repaid early, the amortisation period is adjusted to follow the pattern of annual savings identified for the refinancing, up to a maximum of 20 years (or five years if there is no refinancing). Authorities are permitted to set a shorter amortisation period for each category. Amortisations should be straight line, except in the case of replacement loans taken out on an annuity basis, where the interest profile should be followed. General Fund charges can be avoided by financing premiums from capital receipts.

B20 These provisions are effected in the Movement in Reserves Statement, after debits and credits have been made to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement in line with the Code's requirements. The adjustments made in the Movement in Reserves Statement are managed via the Financial Instruments Adjustment Account, which records the timing differences between the rate at which gains

and losses are recognised under the Code and the rate at which debits and credits are required to be made against council tax.

ILLUSTRATION: ACCOUNTING FOR REGULATIONS/STATUTORY GUIDANCE ON PREMIUMS AND DISCOUNTS

Plynne Keyplonque Council repaid a loan on 1 September and was charged a premium of £250,000. The council applies the statutory provisions to spread the impact of the premium over what would have been the remaining term of the loan repaid – five years.

The accounts entries in the year that the loan is repaid are:

Dr	Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure	£250,000
Cr	Cash	£250,000
Recognising the payment of the premium as a loss		
Dr	Financial Instruments Adjustment Account	£225,000
Cr	General Fund Balance	£225,000
Reconciling the charge against the General Fund Balance to the £25,000 charge permitted by statutory provisions (one tenth of the premium amount, representing the first six months of the five-year spreading period) (via the Movement in Reserves Statement)		

The accounts entries in the four subsequent years are:

Dr	General Fund Balance	£50,000
Cr	Financial Instruments Adjustment Account	£50,000
Reconciling the charge against the General Fund Balance to the £50,000 charge permitted by statutory provisions (via the Movement in Reserves Statement)		

For the last six months of the spreading in the sixth year, the accounts entries are:

Dr	General Fund Balance	£25,000
Cr	Financial Instruments Adjustment Account	£25,000
Reconciling the charge against the General Fund Balance to the £25,000 charge permitted by statutory provisions (via the Movement in Reserves Statement)		

B21 The regulations for England and Wales and the statutory guidance for Scotland set out the maximum period over which premiums may be charged to the General Fund. The regulations also allow authorities to make a higher charge to the General Fund (ie shorten the spreading period), and authorities will wish to consider whether it would be prudent to do so. Housing authorities in Wales remain subject to the annual Item 8 Determinations which require premiums and discounts to be split between the HRA and the General Fund in accordance with the Determination and that the HRA share is 100% funded from HRA subsidy. In England, the detailed specifications in relation to the HRA apportionment of premiums and discounts are no longer included in the Item 8 Determination. The determination requires authorities to calculate these charges or credits in accordance with proper accounting practices which reflect the statutory requirements of the regulations set out in paragraph B19 above and the provisions of the Code. Local authorities in England will need to ensure that a

fair apportionment of these charges and credits is made between the General Fund and the HRA.

Regulations and Statutory Guidance Relating to Other Financial Liabilities

B22 In addition to the provisions relating to premiums and discounts, there are other concessions available that allow the Financial Instruments Adjustment Account to be used to manage the impact on the General Fund Balance. At the date that these Guidance Notes were being prepared for publication, the following provisions were effective.

	England	Wales	Scotland
Source of provisions	**The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414)**	**The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2008 (SI 2008/588 (W.59))**	**Statutory guidance issued under section 12(2)(b) of the Local Government in Scotland Act 2003 on 30 March 2007 as Finance Circular 4/2007**
Loans with stepped interest	Where an authority has taken out a loan before 9 November 2007 that has an interest rate that increases in one or more increments during its term, the ultimate charge to revenue each year is to be either that calculated in accordance with proper accounting practices or the amount of interest that is due to be paid that year according to the loan agreement. No provisions for loans entered into on or after 9 November 2007.	Where an authority has taken out a loan before 21 January 2008 that has an interest rate that increases in one or more increments during its term, the ultimate charge to revenue each year is to be either that calculated in accordance with proper accounting practices or the amount of interest that is due to be paid that year according to the loan agreement. No provisions for loans entered into on or after 21 January 2008.	No increase in the cumulative interest charge to the General Fund for loans held at 31 March 2007 and outstanding at the start of the relevant year as a result of charging the Comprehensive Income and Expenditure Statement with interest calculated on the amortised cost basis. Annual charge to the General Fund for interest on loans held at 31 March 2007 to be limited to that which would have been chargeable if the authority's accounting policy for 2006/07 were to continue to be applied. Schedule to be kept reconciling Income and Expenditure debits to net charge against the General Fund Balance. Loans with stepped interest features taken out from 1 April 2007 to be accounted for in accordance with the Code in force for relevant year. Loans to lose protection if extended or modified.

	England	Wales	Scotland
Financial guarantees	■ Where an authority has given a financial guarantee before 9 November 2007, the ultimate charge to revenue each year is to be the figure calculated per current proper accounting practices (ie applying the financial instruments provisions set out in this module) or per proper accounting practices as they applied in 2006/07 (ie provision accounting under FRS 12) (see paragraphs B27 to B36). ■ No provisions for guarantees given on or after 9 November 2007.	■ Where an authority has given a financial guarantee before 21 January 2008, the ultimate charge to revenue each year is to be the figure calculated per current proper accounting practices (ie applying the financial instruments provisions set out in this module) or per proper accounting practices as they applied in 2006/07 (ie provision accounting under FRS 12) (see paragraphs B27 to B36). ■ No provisions for guarantees given on or after 21 January 2008.	None.

B23 Where an authority takes advantage of these provisions, the use of the Financial Instruments Adjustment Account follows a straightforward process. The reconciling entries for the General Fund Balance required in the Movement in Reserves Statement are posted to the Financial Instruments Adjustment Account.

Summary of Accounting Requirements for PWLB Loans

B24 In terms of treasury management, the most straightforward financial instruments held by local authorities are probably loans from the PWLB. However, in accounting terms they do have complexities. Loans with variable interest rates are not problematic, but loans at fixed interest rates bring with them problems of fair valuation and of evaluation of the effects of early repayment terms offered by the PWLB.

B25 Issues have been complicated by the change in PWLB policy effective from 31 October 2007 to use a different rate from the new borrowing rate for calculating the amount payable on the early repayment of loans.

B26 Apart from consideration of the fair value implications of early repayment terms, the accounting process is then relatively straightforward:

- **Transaction costs** – at 35p for every £1,000 borrowed, PWLB fees are almost certainly going to be immaterial for all authorities. Costs will then be written off to revenue as they are incurred.
- **Carrying amount** – without significant transaction costs and complicated interest rate structures, all PWLB loans will be recognised at the principal amount when the loan is taken out. In formal accounting terms, the loans are required to be carried at amortised cost. However, amortised cost will always (with one exception – see next bullet) be the

outstanding principal amount, whether loans are fixed or variable rate or the repayment basis is annuity, maturity or equal instalments of principal.

- **Interest costs** – the amortised cost of a loan is based on full accruals as per paragraph 7.1.8.1 of the Code. Consequently, where interest is due but has not been paid, amortised cost increases. Accrued interest should be charged to the Surplus or Deficit on the Provision of Services and added to the value of the loan (the entries will be Dr Surplus or Deficit on the Provision of Services, Cr Borrowing). This will increase the carrying value of the loan until such time as the accrued interest is paid. Paragraph 7.4.6.1 of the Code would anticipate amortised interest to be included in current liabilities (provided that this does meet the definition of a current liability (see Module 3 and section D of this module) along with any other current elements of the loan).
- **Fair value** – although PWLB loans are carried in the Balance Sheet at amortised cost, the fair value of loans is required to be disclosed in a note. This requires a calculation of the net present value of the cash flows that are scheduled to take place over the remaining life of each loan.
- For variable rate loans, fair value will be the same as the amortised cost. For fixed rate loans, fair value will be different from amortised cost if the fixed rate is different from prevailing interest rates. This is because a fixed rate will lead to an authority being locked into paying more or less interest than it would have in comparison with a variable rate loan. The fair value therefore measures the present value of this notional interest gain/loss.
- There is a question as to how the fair value should be calculated, with two options for the comparator PWLB interest rate available: the rate available for new borrowing or the early repayment rate. There is no definitive solution as fair value requires the hypothesis of an arm's-length transaction. It is arguable that the early repayment rate is ineligible because it was imposed upon the authority. However, authorities are unable to reassign loans, so there is no ability to exit a PWLB loan other than to accept the repayment terms offered by the PWLB, so it is difficult to hypothesise a reassignment using the new borrowing rate.
- A case can be made for either interest rate to be used for the calculation. The new borrowing rate will calculate the notional interest gain/loss that will accrue if the authority keeps the loan until maturity. The repayment rate gives the actual amount that an authority would have to pay to avoid the loss or realise the notional gain. Authorities should consider which measure will be more relevant to the readers of the accounts, or whether both should be disclosed. The basis of the measure(s) used should be disclosed, and authorities are advised to discuss their approach with their auditor.
- **Restructuring** – the PWLB is not a party to formal restructurings of individual loans, and authorities manage their portfolios by repaying loans on the stated terms for early settlement and taking out new loans on the stated terms for new borrowing. As a result, cash outflows and inflows are required.

Financial Guarantee Contracts

B27 Financial guarantee contracts are arrangements requiring the giver of the guarantee to make specified payments to reimburse the holder for a loss it would incur if a specified debtor

fails to make payments due under a debt instrument. In the private sector, such guarantees would be given in two main cases:

- guarantees given by a parent company to its group companies
- as a commercial venture, where the giver of the guarantee will charge a premium in return for taking on the risk of having to make payments.

B28 In local government, commitments meeting the definition of financial guarantees will commonly be given for policy reasons, supporting a voluntary organisation or a local company to provide services or make facilities available that might otherwise have been financed by the authority. Authorities might choose to negotiate no direct financial benefit from giving such guarantees. It is therefore in practice more likely that a financial guarantee would be a liability for a local authority rather than neutral or an asset.

B29 It should be noted that the definition only extends to guarantees related to the performance of another party in relation to a debt instrument. All other guarantees fall to be considered under IAS 37 *Provisions, Contingent Liabilities and Assets.*

B30 The Code's accounting requirements for financial guarantees are:

- They are to be recognised initially at fair value.
- Where the contract is issued in a stand-alone arm's-length transaction to an unrelated party, fair value is the premium received, unless there is evidence that this is not a reliable estimate.
- If no premium is received, fair value at inception should be estimated by considering the probability of the guarantee being called and the likely amount payable.
- Where the guarantee has a fair value but no premium was secured by the authority, this absence should be recorded as a loss in the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement (normally to the service revenue account that is taken to benefit from the giving of the guarantee).
- A schedule will then be drawn up for amortising the fair value of the guarantee over the period of the underlying risk exposure, if the exposure is expected to fall over the life of the guarantee (to match the expected change in that exposure, eg if the borrower makes periodic payments of principal), as the services rendered by the authority are taken to have been provided.
- Subsequently, the guarantee is measured at the higher of:
  - the amount initially recognised applying the financial instruments rules (less amortisation)

  and

  - the amount that would be determined for a provision in accordance with IAS 37.

  This means that the carrying amount will be based on the original amount unless and until payment under the guarantee becomes probable and a provision is calculable under IAS 37 (with that provision being greater than the unamortised fair value).
- All movements on the carrying amount of the liability, whether amortisations of the initial fair value or movements following a switch to an IAS 37 measurement, are debited or credited to the Surplus or Deficit on the Provision of Services (preferably to the service

revenue account that is taken to benefit from the giving of the guarantee, if the benefit can be ascribed to a particular service or services).

- Any consideration received for granting the financial guarantee should be credited to Surplus or Deficit on the Provision of Services.

B31 The major problem facing authorities will be assessing the fair value of the level of benevolence granted when a guarantee is given. The fact that no premium has been received by an authority is not necessarily an indication of a zero value. Of greater significance will be the fact that the authority will now potentially be required to make a settlement to be released from the obligation or to pay another party to take the obligation on. If this is the case, then a loss has been incurred on entry into the contract that will be reflected in the Surplus or Deficit on the Provision of Services.

B32 Where an authority has to assess fair value on inception, the Code recommends that consideration be given to the probability of the guarantee being called and the likely amount payable under the guarantee: the objective will be to measure the risk taken on by the authority. Each guarantee will have its own particular characteristics. The contract might include exit clauses, and an indication of fair value could be the exit price, net of any penalty charges. Alternatively, an assessment could be made of the difference between the higher cost of borrowing that the other party would have incurred if the guarantee had not been given and the cost of the borrowing actually taken out.

B33 In the absence of any more objective information, an authority could, in deciding to give the guarantee, have set out the various scenarios that are feasible under the guarantee (including not having to make any payments) and assessed a probability for each one – the measure of fair value would then be the weighted average of the discounted value of the scenarios. For example, if an authority assesses that there is a 70% probability that the guarantee will not be called, a 20% probability that it will have to pay £500,000 (at present value) and a 10% probability of having to pay £1m, the weighted average of these scenarios would be £200,000, ie £500,000 x 0.2 plus £1m x 0.1.

B34 In making an assessment of fair value, an authority should also take into account any benefits that might flow to it as a result of the guarantee being called. For instance, if the loan to the other party was for the construction of property, the authority might receive title to the property if the guarantee is called.

B35 The following example sets out the accounting process for a financial guarantee.

ILLUSTRATION: ACCOUNTING FOR A FINANCIAL GUARANTEE

At the start of Year 1, Ninn Keenonk Council gives a guarantee on behalf of Keenonk Community Association, committing it to repay the principal amount of £500,000 if the association defaults on any payments due under the loan it has taken out from the BatNest Bank. The loan relates to the construction of new facilities for day care for older people and has a term of five years. It is being repaid by equal annual instalments of principal.

The council has not secured any compensation in return for giving the guarantee, but assesses a fair value of £120,000. The guarantee was given on the presumption that it was probable that it would not be called. However, at the end of Year 3 the council becomes aware that the association is having financial difficulties and has not paid the Year 3 instalment of principal. It is assessed that it is probable that the guarantee will now be called. At the start of Year 4, however, the association secures a donation that enables it to make

the Year 3 repayment before the bank called the guarantee and to meet the repayments of the loan at the end of Years 4 and 5.

The accounting entries (assuming that discounting would not be material) will therefore be:

In Year 1:

Dr	Comprehensive Income and Expenditure Statement – Adult Social Care	£120,000
Cr	Financial Liabilities	£120,000
To record the loss incurred in giving the guarantee		
Dr	Financial Liabilities	£24,000
Cr	Comprehensive Income and Expenditure Statement – Adult Social Care	£24,000
To amortise the initial fair value over the life of the guarantee, reflecting the reduction in exposure as a result of the Year 1 repayment by the association		

In Year 2:

Dr	Financial Liabilities	£24,000
Cr	Comprehensive Income and Expenditure Statement – Adult Social Care	£24,000
To amortise the initial fair value over the life of the guarantee, reflecting the reduction in exposure as a result of the Year 2 repayment by the association		

In Year 3:

Dr	Comprehensive Income and Expenditure Statement – Adult Social Care	£228,000
Cr	Financial Liabilities	£228,000
To provide for the calling of the guarantee – the difference between the possible £300,000 call and the carrying amount of the guarantee of £72,000 (£120,000 net of two amortisations of £24,000)		

In Year 4:

Dr	Financial Liabilities	£276,000
Cr	Comprehensive Income and Expenditure Statement – Adult Social Care	£276,000
To move from the £300,000 provision back to measurement at amortised initial value as £24,000 following the change in probabilities of the guarantee being called (£120,000 net of four amortisations of £24,000)		

In Year 5:

Dr	Financial Liabilities	£24,000
Cr	Comprehensive Income and Expenditure Statement – Adult Social Care	£24,000
To amortise the remaining amount of the financial liability at the end of the guarantee period		

B36 The statutory provisions in place that allow authorities in England and Wales to reverse out the impact of these debits and credits on the General Fund Balance are summarised in paragraph B22. However, authorities should note that these do not apply to any guarantees given on or after 9 November 2007 (England) and 21 January 2008 (Wales). There are no reversal provisions for Scottish authorities.

C ACCOUNTING FOR FINANCIAL ASSETS AFTER INITIAL RECOGNITION

Please see the following section of the Code

Section 7.3

C1 Apart from those transactions that would fall to be treated as 'fair value through profit and loss' (see section A of this module), financial assets are accounted for using one of two models:

- **loans and receivables** – these are assets that have fixed or determinable payments and are not quoted in an active market; they are accounted for using the amortised cost model
- **available for sale** – this category covers all other assets that do not meet the 'loans and receivables' criteria; they are accounted for using the fair value model.

Note that the models are applied to all financial assets that meet this definition, even if they are separately identified on the face of the Balance Sheet (eg trade receivables). However, in the latter case, the potential differences between historical cost and amortised cost/fair value are likely to be immaterial. Note also that assets arising purely from statutory provisions (eg council tax, NDR and general rates) are exempt from the definition of financial assets, which requires a contractual basis (eg housing rent arrears).

C2 The Code does not permit authorities to use the 'held-to-maturity' classification in IAS 39. This would otherwise apply to an asset that has fixed or determinable payments and the entity has a positive intention and ability to hold until maturity. Under IAS 39, an entity would be able to designate this asset as held to maturity and avoid any need to carry the instrument at fair value, but at the risk of penalties if the asset is sold before maturity or the policy becomes tainted. In order to retain comparability, the Code has not adopted this optional category. Note that in practical terms the treatment of asset as 'available for sale' will have the same effect as a 'held to maturity' classification.

Loans and Receivables

C3 The two criteria that have to be met in order for an instrument to qualify as a loan or receivable are:

- **Fixed or determinable payments** – this criterion does not require that payments are scheduled out precisely under the instrument, but that the contractual arrangement defines the dates and the amounts of payments:
  - the maturity date must be fixed, and
  - principal and interest payments are fixed, or
  - principal and interest payments will be determined by terms in the contract that refer to a source measure (such as LIBOR) that allows calculation of the amounts payable once the value of the source measure is known.
- **Not quoted in an active market** – for this to be the case, quoted prices must not be readily and regularly available for the instrument from an exchange, dealer, broker,

industry group, pricing service or regulatory agency. Where prices are available, the definition as a Loan and Receivable will still apply to assets with fixed or determinable payments where these prices do not represent actual and regularly occurring market transactions on an arm's-length basis.

The criteria are measured against the current status of the instrument. Assets do not necessarily have to have been originated by an authority but might have been acquired/ purchased.

C4 Assets of this type will arise where an authority provides money, goods or services to another party and contracts to defer the settlement of the debt that arises, but in the meantime will not (or cannot) plan to trade the receivable on the market. Examples of such assets include debtors arising from the provision of services, bank deposits and loans made to other parties (such as car loans to officers).

C5 An example of an asset that would **not** qualify to be a loan or receivable would be a holding of ordinary shares in a private company. In this instance there would be no fixed or determinable basis for payments.

C6 IAS 39 allows instruments that meet the loans and receivable definition to be redesignated into another class of financial assets, but the Code does not give authorities this flexibility, in order to maintain consistency of financial reporting across local government.

Accounting Arrangements for Loans and Receivables

C7 The accounting arrangements for loans and receivables are set out below.

Loans and Receivables – Amortised Cost	
Measurement basis for the Balance Sheet	The asset is maintained in the Balance Sheet at amortised cost: ■ Initial measurement will be at fair value – normally the amount of the originating transaction, such as the payment of a loan advance – plus transaction costs. ■ The effective interest rate is then calculated – the rate of interest that will discount the estimated cash flows that will take place over the life of the instrument (principal and interest) to the amount in the Balance Sheet at initial measurement. ■ This results in a carrying amount (the amortised cost) and an effective interest rate that might be different from the amounts specified as being principal and interest in the contract (although for most assets, such as loan advances at fixed interest or at variable rates linked to base rates, and without significant transaction costs, the two should be the same). The amortised cost in the Balance Sheet then changes as: ■ interest based on the amortised cost for the year is credited to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement (see below) ■ cash is received from the borrower (for either principal or interest). For example, if the credit to Surplus or Deficit on the Provision of Services for the year is £100,000 but the authority has received £70,000 for principal and £110,000 for interest that year, the amortised cost in the Balance Sheet will reduce by £80,000 (100 – (70 + 110)). There are no revaluations to fair value at any point in the instrument's life once it has been measured initially.

Loans and Receivables – Amortised Cost	
Accounting for gains and losses	All gains and losses are recognised in the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement: ■ investment income, calculated by applying the effective interest rate to the amortised cost for the year, is credited to the Surplus or Deficit on the Provision of Services ■ where impairment losses are identified, these are debited to the Surplus or Deficit on the Provision of Services ■ any gains and losses that arise when the asset is derecognised (eg because the fair value has changed as a result of changes in market interest rates or because a premium becomes payable on early redemption) are debited or credited to the Surplus or Deficit on the Provision of Services.

C8 The principles to be followed in accounting for a loan or receivable are therefore generally the same as would be applied to a financial liability, with the transactions and balances that would be recognised by a lender mirroring those recognised by a borrower. Consequently:

- The amortised cost using the effective interest rate is maintained on the same basis as in paragraphs B2 to B6 of this module, but with cash flows reversed and debits and credits switched.
- Estimations of the expected life and cash flows of a financial asset follow the same process as for a financial liability, as set out in paragraphs B8 and B9.
- If an authority agrees to the early repayment of a financial asset that is a loan or receivable and receives a premium or allows a discount on the outstanding principal amount, the gain or loss should be posted to the Surplus or Deficit on the Provision of Services at the point that the contract is terminated.
- There are no statutory provisions that allow (or require) the Surplus or Deficit on the Provision of Services transactions to be adjusted for in the Movement in Reserves Statement (eg to spread the impact of a discount given).

Impairment of Loans and Receivables

C9 An important difference between financial assets and liabilities carried at amortised cost is that financial assets may suffer impairment. The expected approach to assessing whether impairment has taken place is set out in paragraphs C27 to C32. The accounting process for an impaired loan or receivable will be as follows:

- An impairment will arise where the estimated recoverable amount is less than the amortised cost at which the asset is being carried.
- The estimated recoverable amount is the present value of the cash flows now expected to take place over the remaining term of the instrument, discounted using:
  - for fixed rate instruments, the original effective interest rate (even where current market rates are higher or lower)
  - for variable rate instruments, the current variable rate determinable under the contract (See IAS 39, paragraph AG84).
- The carrying amount of the asset in the Balance Sheet is reduced to the estimated recoverable amount (the carrying amount to include interest accrued up to the date of

impairment). Paragraph 7.3.3.6 of the Code allows this to be done either by adjusting the asset or by establishing an allowance account to sit alongside the asset.

- The amount of the reduction in the carrying amount of the asset is debited to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement.
- Interest income over the remaining term of the instrument is recognised by applying the **original** effective interest rate to the revised balance (this credit is designed to unwind the discounting recognised in the impairment calculation).
- If an impairment loss is subsequently reduced (eg because the borrower recovers from financial difficulties) and the decrease can be identified to an event that took place after the impairment was recognised, the impairment loss should be reversed. If the decrease cannot be identified to an event that took place after the impairment was recognised, the impairment is not reversed; any gain will be recognised at the point the financial asset is derecognised (eg when the final settlement is received). The uplift is limited to the amount of the amortised cost that would have been effective at the date of the reversal if the impairment had not been made, and is matched by a credit to Surplus or Deficit on the Provision of Services.

C10 The following example shows how an impairment will affect the accounting treatment of a loan or receivable.

ILLUSTRATION: IMPAIRMENT OF A LOAN OR RECEIVABLE

On 1 April 20PP, Wottingers Council purchased a £1m five-year bond with semi-annual interest of 5% payable on 30 September and 31 March. The bond is not quoted in an active market. The price paid was £1,081,110, reflecting a bond premium of £81,110. The effective interest rate is 8% (4% on a semi-annual basis). As the interest is payable twice a year, the amortised cost is calculated using a six-monthly discounting framework:

	Amortised cost b/f £ A	Interest credit £ B A x 4%	Interest receivable £ C £1m x 5%	Amortised cost c/f £ D A + B – C
Year 1 – first half	1,081,110	43,244	50,000	1,074,354
Year 1 – second half	1,074,354	42,974	50,000	1,067,329
Year 2 – first half	1,067,329	42,693	50,000	1,060,022
Year 2 – second half	1,060,022	42,401	50,000	1,052,423
Year 3 – first half	1,052,423	42,097	50,000	1,044,519
Year 3 – second half	1,044,519	41,781	50,000	1,036,300
Year 4 – first half	1,036,300	41,452	50,000	1,027,752
Year 4 – second half	1,027,752	41,110	50,000	1,018,862
Year 5 – first half	1,018,862	40,754	50,000	1,009,617
Year 5 – second half	1,009,617	40,387	50,000	1,000,000

The bond is not quoted on a market and is thus being accounted for under the Loans and Receivables heading.

The council received all four scheduled payments of interest due of £50,000 in Year 1 and Year 2. At the end of Year 2, the amortised cost of the asset was thus £1,052,423.

The issuer of the bond fell into financial difficulties and has not made the two payments due in Year 3. Following discussions with the issuer, the council decides that the bond has become impaired, with the best estimate of future cash flows being a £200,000 payment at the end of Year 4 and a final settlement of £700,000 at the end of Year 5, the scheduled maturity date.

Although the bond is 'non-performing', the council is required under the effective interest rate methodology to account for the addition of interest income for Year 3 but to ignore the £50,000 deduction for the actual payment of interest. The previously scheduled amortised cost will therefore increase, as will the interest income credit. On this basis, the amortised cost of the bond at the end of Year 3 is £1,138,301 (see below for calculation).

In order to calculate the impairment loss in the Year 3 accounts, the council needs to calculate the estimated recoverable amount at the end of Year 3. This is obtained by discounting the expected cash flows at the original effective interest rate. (Because of the change in the pattern of cash flows, discounting is on an annual basis, rather than the semi-annual basis used previously in the example.) This results in a recoverable amount of £785,322 for the projected receipts of £200,000 and £700,000 – £185,185 and £600,137 after discounting at 8% for one year and two years respectively.

The impairment loss to be recognised in Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement is therefore:

	£
Amortised cost at end of Year 2	1,052,423
Accrual of interest income in the Surplus or Deficit on the Provision of Services for first half of Year 3 at 4%	42,097
	1,094,520
Accrual of interest income in the Surplus or Deficit on the Provision of Services for second half of Year 3 at 4%	43,781
Amortised cost at end of Year 3	1,138,301
Estimated recoverable amount at end of Year 3	(785,322)
Impairment loss recognised in the Surplus or Deficit on the Provision of Services	352,979

For the remaining life of the bond, interest income will now be credited to the Surplus or Deficit on the Provision of Services on the basis of 8% applied annually to the estimated recoverable amount: £62,826 and £51,852. Together with the actual payments of £200,000 and £700,000, this will reduce the carrying value of £785,322 to zero by the maturity date.

Regulations and Statutory Guidance on Loans and Receivables

C11 At the time that these Guidance Notes were being prepared for publication, there were no statutory provisions that supersede the accounting arrangements for loans and receivables other than those for soft loans and for impairment losses in relation to bank deposits.[2] Where an authority receives premiums or awards discounts on the premature repayment of a loan or suffers an impairment loss, the debit or credit to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement will flow through to the bottom line of the General Fund Balance. The provisions in relation to soft loans are as follows.

	England	Wales	Scotland
Source of provisions	**The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2007 (SI 2007/573)**	**The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2007 (SI 2007/1051 (W.108))**	**Statutory guidance issued under section 12(2)(b) of the Local Government in Scotland Act 2003 on 30 March 2007 as Finance Circular 4/2007**
Soft loans	Where an authority includes a loan in its Balance Sheet at less than the principal amount outstanding, the amount of interest credited to the revenue account each year is to continue to be based on the interest due to be received in accordance with the loan agreement.	Where an authority includes a loan in its Balance Sheet at less than the principal amount outstanding, the amount of interest credited to the revenue account each year is to continue to be based on the interest due to be received in accordance with the loan agreement.	Where loans to third parties at less than commercial interest rates were made before 1 April 2007 and were written down to fair value on that date, the annual amount credited to the General Fund Balance is to be the contractual interest receivable. Loans are to lose their protection if extended or modified. No provisions for loans made on or after 1 April 2007.

2. For England and Wales this reference is included to maintain the historic references to the Icelandic Bank transactions.

The provisions in relation to the impairment of bank deposits are as follows:

	England	Wales	Scotland
Source of provisions	**The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2009 (SI 2009/321)**	**The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2009 (SI 2009/560 (W.52)) as amended by The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2010 (SI 2010/685 (W.67))**	**Statutory guidance issued under section 12(2)(b) of the Local Government in Scotland Act 2003 on 30 March 2011 as Finance Circular 5/2011. (Prior to this Finance Circular 4/2009 applied.)]**
Impairment of bank deposits[3]	Where an authority had an investment with a bank that experienced a loss event between 1 April and 26 November 2008, any amount of the impairment loss relating to the capital sum invested was able to be deferred as a debit against the General Fund Balance until 2010/11.	Where an authority had an investment with a bank that experienced a loss event between 1 April and 27 November 2008, any amount of the impairment loss relating to the capital sum invested was able to be deferred as a debit against the General Fund Balance until 2011/12.	Finance Circular 5/2011 may be applied where an authority had an investment with a bank that experienced a loss event between 1 October 2008 and 31 March 2009. The charge to the General Fund may be limited to the cash loss position (ie the final anticipated cash loss for a relevant investment) rather than an impairment charge calculated using the amortised cost method. An 'Icelandic banks statutory adjustment account' is used, with a disclosure note required detailing the adjustments made.

Available-for-Sale Financial Assets

C12 The available-for-sale category covers all those financial assets that have not been allocated either to the Loans and Receivables category, ie:

- assets that do not have fixed or determinable payments (eg equity shares in companies)
- assets that do have fixed or determinable payments but are quoted in an active market (eg gilts, corporate bonds, unit trusts, etc)

or to the Fair Value through Profit or Loss category (see section A), ie:

3. For England and Wales these references are included to maintain the historic references to the Icelandic Bank transactions.

- assets that are held for trading or are part of a portfolio of instruments managed together and for which there is evidence of a recent actual pattern of short-term profit taking will not be available for sale.

Accounting for Available-for-Sale Financial Assets

C13 The key accounting requirement for available-for-sale assets is that, unlike loans and receivables, they continue to be carried at fair value and will need regular revaluation. The accounting arrangements for available-for-sale assets are set out below.

Available-for-Sale Financial Assets – Fair Value	
Measurement basis for the Balance Sheet	The asset is maintained in the Balance Sheet at fair value: ■ Initial measurement will be at fair value – normally the amount of the originating transaction, such as the payment for an equity share or the purchase of a bond – plus transaction costs. ■ For assets with fixed or determinable payments (eg bonds), the effective interest rate is then calculated – the rate of interest that will discount the estimated cash flows that will take place over the life of the instrument (principal and interest) to the amount in the Balance Sheet at initial measurement. ■ This results in a carrying amount (the amortised cost) and an effective interest rate that might be different from those specified in the contract (although for most assets, such as loans at fixed interest or at variable rates linked to base rates, and without significant transaction costs, the two should be the same). The amortised cost is then used as the basis for calculating interest income and as a benchmark against which to assess the accounting treatment of movements in fair value. ■ The asset carried in the Balance Sheet is then updated as fair value changes. Fair value is assessed by reference to quoted market prices or by use of a valuation technique (such as the discounting of future cash flows). ■ For an asset with fixed payments (eg fixed rate bond), fair value as measured by the market price will change as interest payable accrues (increase), as interest payable is settled (decrease), and as the benefits/disbenefits represented by premiums and discounts on initial recognition are consumed (decrease and increase respectively). Movements in fair value will also arise where changes in market conditions make the fixed payments more or less attractive in comparison with prevailing interest rates. ■ For an asset with determinable payments (eg variable rate bond), fair value as measured by the market price will change as interest payable accrues (increase), as interest payable is settled (decrease), and as the benefits/disbenefits represented by premiums and discounts on initial recognition are consumed (decrease and increase respectively). Movements in fair value will also arise where the variables underlying the determinable payments change differentially to movements in prevailing market rates.

Available-for-Sale Financial Assets – Fair Value	
Measurement basis for the Balance Sheet (continued)	■ For an asset with no fixed or determinable payments (eg shares), fair value will change as expectations arise for payments to fall due under the instrument, payments are made or other market forces influence the value of the investment. ■ Where the instrument is a short-term receivable with no quoted interest rate (eg a trade debtor), then it should be carried at the original invoice amount. (This treatment will depend on it being unlikely that there will be any material difference between invoice amount and fair value, which will depend on a combination of the amount outstanding, the period for which credit is being granted and prevailing rates. There is thus no prescribed definition of 'short term'.)
Accounting for gains and losses	Gains and losses are recognised differentially in the Comprehensive Income and Expenditure Statement: ■ Interest income is recognised in the Surplus or Deficit on the Provision of Services on the basis of applying the effective interest rate to the amortised cost of the asset. ■ Dividends are credited to the Surplus or Deficit on the Provision of Services when the right for the authority to receive the payment is established. ■ Gains and losses arising on movements in fair value are posted to Other Comprehensive Income and Expenditure, and the change in the amount of the investment in the Balance Sheet is matched with an entry in the Available-for-Sale Reserve. ■ The exception to the treatment in the preceding bullet is where impairment losses have been incurred – these losses are charged to the Surplus or Deficit on the Provision of Services, after removing the effect of accrued interest on valuations (which will have been taken into account in the Surplus or Deficit on the Provision of Services). Any cumulative losses previously recognised in the Available-for-Sale Reserve are charged to the Surplus or Deficit on the Provision of Services. ■ When the asset is derecognised, the cumulative gain or loss previously recognised in Other Comprehensive Income and Expenditure shall be transferred from the Available-for-Sale Reserve and recognised in the Surplus or Deficit on the Provision of Services.

C14 The principles to be followed in accounting for an available-for-sale financial asset can be complex, mixing the requirement to carry out many of the same calculations of effective interest rates and amortised cost as for loans and receivables at the same time as the carrying amount in the Balance Sheet is adjusted for changes in fair value. Particular points of note are:

- Where an available-for-sale asset has fixed or determinable payments, much of the accounting process will be the same as for loans and receivables as fair value measured by the market price will change as a result of:
  - the benefits represented by any premium paid to acquire an instrument with an above-market interest rate being consumed incrementally as interest under the instrument becomes receivable

- where a discount is made to the purchase price of an instrument with a below-market interest rate, the disbenefit will reduce each time an interest payment is made
- the fair value of an instrument will increase as interest receivable accrues on it, and will fall as interest is actually paid.

- The effects of these movements are programmed into the accounting process for crediting interest income to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement using the effective interest rate and amortised cost. The principles applied in paragraphs B2 to B9 of this module should therefore be applied in scheduling out interest income to be recognised in the Surplus or Deficit on the Provision of Services:
  - the amortised cost using the effective interest rate is maintained on the same basis as in paragraphs B2 to B6 but with cash flows reversed and debits and credits switched
  - variations in interest rates (either programmed or arising as a result of movements in market rates) affect the amortised cost of an asset in the same way as for a liability per paragraph B7
  - estimations of the expected life and cash flows of a financial asset follow the same process as for a financial liability, as set out in paragraphs B8 and B9. The accounting entries in relation to interest income and actual income receivable will accomplish the dual task of reflecting gains and losses in the Surplus or Deficit on the Provision of Services and adjusting the fair value to the market price in the Balance Sheet:

    Dr Investments
    Cr Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure
    Accounting for interest income based on amortised cost multiplied by the effective interest rate – this is effectively accrued interest receivable under the instrument, adjusted for the amortisation of any premiums or discounts reflected in the purchase price

    Dr Cash
    Cr Investments
    Writing down the value of the investment after accrued interest is paid

- Where factors other than those pre-programmed into an instrument with fixed or determinable payments cause the fair value to change (such as a shift in market rates making a fixed rate instrument more or less attractive), these movements are accounted for separately as revaluations. The movement can usually be calculated by comparing the quoted market price or the value of the new estimated cash flows discounted at the market rate prevailing at the date of valuation. The revaluation gain or loss should be the difference between the newly assessed fair value and the amortised cost previously calculated to apply at the valuation date, adjusted to exclude any accrued interest from the movement in fair value (as this will have been recognised in the Surplus or Deficit on the Provision of Services). The accounting entries will be:

Dr Investment
Cr Available-for-Sale Reserve
To reflect an increase in fair value

Dr Available-for-Sale Reserve
Cr Investment
To reflect a decrease in fair value that is not due to an impairment – this would apply where the value of an investment is changing with movements in the market rate of interest, as opposed to a possibility that the payments due under the terms of the instrument might not take place as contracted

- The Available-for-Sale Reserve is a revaluation reserve introduced to manage the fair value process for these financial assets. It is permitted to have a negative value provided that the losses posted to it are not impairment losses.
- Revaluation gains and losses on assets with fixed or determinable payments will normally be consumed or be abated over the remaining life of the instrument as the fixed maturity point approaches. Consequently, the amount recognised in the Available-for-Sale Reserve will be written back to the investment carried in the Balance Sheet incrementally as payments are made under the instrument and the cumulative gain/loss that might have been made/incurred from selling the instrument reduces.
- Where the instrument does not have fixed or determinable payments (such as an equity share), fair value will be determined by reference to a quoted market price or by use of a valuation technique. Any income from the instrument (such as a dividend) will be accrued for in the Surplus or Deficit on the Provision of Services when the right for the authority to receive the payment is established. Where this is the case, any movements in the fair value attributable to the accrual will be ignored in calculating any revaluation gain/loss that is to be posted to the Available-for-Sale Reserve.
- Where any balance is left on the Available-for-Sale Reserve when an asset is derecognised, the amount is cleared to the Surplus or Deficit on the Provision of Services.
- If an authority agrees to the early repayment of a financial asset that is available for sale and receives a premium or allows a discount on the outstanding principal amount, the gain or loss should be posted to the Surplus or Deficit on the Provision of Services at the point that the contract is terminated.

C15 The following examples show the complexities involved in accounting for a financial asset at fair value, where the asset has fixed payments (where payments are fixed, then the market price can be calculated from first principles against prevailing interest rates):

- the first example shows how a bond would be accounted for if there were no movements in economic conditions (ie prevailing interest rates) that would affect the fair value of the bond
- the second example shows how a movement in economic conditions that affected the fair value would be taken into account.

ILLUSTRATION: FAIR VALUE ACCOUNTING FOR AN AVAILABLE-FOR-SALE FINANCIAL ASSET – FIXED/DETERMINABLE PAYMENTS, EXCLUDING MOVEMENTS IN FAIR VALUE DUE TO CHANGING ECONOMIC CONDITIONS

On 1 January 20XX, Uppshigh Daizey Council purchased 10% £10m five-year bonds, with interest payable on 1 January and 1 July each year. The bond's purchase price is £10,811,090. The premium of £811,090 is due to market yield for similar bonds being only 8.16%, such that the bond is paying two percentage points higher than prevailing rates. On the presumption that there are no significant transaction costs, the effective interest rate is 4% semi-annually, calculated over the five-year term of the bond:

	Principal	Interest	Total	Discount Factor	Present Value*
	£	£	£		£
Year 1 – first half	–	500,000	500,000	0.9615385	480,769
Year 1 – second half	–	500,000	500,000	0.9245562	462,278
Year 2 – first half	–	500,000	500,000	0.8889964	444,498
Year 2 – second half	–	500,000	500,000	0.8548042	427,402
Year 3 – first half	–	500,000	500,000	0.8219271	410,964
Year 3 – second half	–	500,000	500,000	0.7903145	395,157
Year 4 – first half	–	500,000	500,000	0.7599178	379,959
Year 4 – second half	–	500,000	500,000	0.7306902	365,345
Year 5 – first half	–	500,000	500,000	0.7025867	351,293
Year 5 – second half	10,000,000	500,000	10,500,000	0.6755642	7,093,424
			15,000,000		10,811,090

* The effective interest rate for the loan is 4% semi-annually – the rate that reduces the cash flows that will take place over the life of the loan down to fair value at initial measurement of £10,811,090.

The bond will therefore be accounted for initially on 1 January 20XX by:

Dr Investments	£10,811,090
Cr Cash	£10,811,090

The amortised cost is then programmed to move in the following way over the life of the bond:

	Fair Value b/f (Amortised Cost)	Interest Credit	Interest Received	Fair Value b/f (Amortised Cost)
	£	£	£	£
	A	B	C	D
		(A x 4%)	(£10m x 5%)	(A + B – C)
Year 1 – first half	10,811,090	432,444	500,000	10,743,533
Year 1 – second half	10,743,533	429,741	500,000	10,673,274
Year 2 – first half	10,673,274	426,931	500,000	10,600,205
Year 2 – second half	10,600,205	424,008	500,000	10,524,214
Year 3 – first half	10,524,214	420,969	500,000	10,445,182

	Fair Value b/f (Amortised Cost) £ A	Interest Credit £ B (A x 4%)	Interest Received £ C (£10m x 5%)	Fair Value b/f (Amortised Cost) £ D (A + B – C)
Year 3 – second half	10,445,182	417,807	500,000	10,362,990
Year 4 – first half	10,362,990	414,520	500,000	10,277,509
Year 4 – second half	10,277,509	411,100	500,000	10,188,609
Year 5 – first half	10,188,609	407,544	500,000	10,096,154
Year 5 – second half	10,096,154	403,846	500,000	10,000,000

With no change in economic conditions, the original amortised cost calculations can be used to represent changes in fair value. As the term of the bond does not match the financial year of the authority, these movements in amortised cost need to be apportioned to the authority's accounting period. As the bond is to be accounted for at fair value, then accruals are made for interest (as compared with the calculation of amortised cost, which only scores interest when it is received):

		Interest Credit £		Interest Received £
	Total Credit	Apportionment (Straight-line Accrual)	Total Receipt	Allocation (Year of Receipt)
Year 1 – first half	432,444	216,222 to each of 20WW/XX and 20XX/YY	500,000	250,000 to each of 20WW/XX and 20XX/YY
Year 1 – second half	429,741	20XX/YY	500,000	20XX/YY
Year 2 – first half	426,931	213,465.5 to each of 20XX/YY and 20YY/ZZ	500,000	250,000 to each of 20WW/XX and 20XX/YY
Year 2 – second half	424,008	20YY/ZZ	500,000	20YY/ZZ
Year 3 – first half	420,969	210,484.50 to each of 20YY/ZZ and 20ZZ/AA	500,000	250,000 to each of 20WW/XX and 20XX/YY
Year 3 – second half	417,807	20ZZ/AA	500,000	20ZZ/AA
Year 4 – first half	414,520	207,260 to each of 20ZZ/AA and 20AA/BB	500,000	250,000 to each of 20WW/XX and 20XX/YY
Year 4 – second half	411,100	20AA/BB	500,000	20AA/BB
Year 5 – first half	407,544	203,772 to each of 20AA/BB and 20BB/CC	500,000	250,000 to each of 20WW/XX and 20XX/YY
Year 5 – second half	403,846	20BB/CC	500,000	20BB/CC

On 31 March 20XX, the authority will thus credit the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement with an accrual for interest income of £216,222 for the

first three months of holding the instrument. This figure effectively comprises £250,000 for actual interest receivable for the first quarter and £33,780 for amortisation of the premium.

The accounting entries are:

Cr Investments (accrued premium)	£33,780
Dr Investments (interest)	£250,000
Cr Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure	£216,222

The fair value of the bond has risen to £11,027,322 – £10,811,100 plus £216,222 – reflecting the fact that unpaid interest of £250,000 has been accrued against it. Amortised cost is £10,777,320 – £10,811,100 less £33,780.

ILLUSTRATION: FAIR VALUE ACCOUNTING FOR AN AVAILABLE-FOR-SALE FINANCIAL ASSET – FIXED/DETERMINABLE PAYMENTS, INCLUDING MOVEMENTS IN FAIR VALUE DUE TO CHANGING ECONOMIC CONDITIONS

On 1 January 20XX, Uppshigh Daizey Council purchased 10% £10m five-year bonds, with interest payable on 1 January and 1 July each year. The arrangements are the same as in the preceding example.

However, in this case on 31 March 20XX, the interest on bonds with a similar maturity and credit risk has moved to 7.75%, so that the bond is now paying two-and-a-quarter percentage points higher than prevailing market rates. At that date, the fair value of the bond has thus risen to £11,125,700 – calculated as 10 cash flows of interest of £500,000 arising at the end of the first and third quarters and a principal payment of £10m at maturity, discounted at the market rate of 3.875% semi-annually from the end of the first quarter.

	Principal	Interest	Total	Discount Factor	Present Value
	£	£	£		£
Year 1 – first quarter	–	500,000	500,000	0.9809933	490,497
Year 1 – third quarter	–	500,000	500,000	0.9443978	472,199
Year 2 – first quarter	–	500,000	500,000	0.9091676	454,584
Year 2 – third quarter	–	500,000	500,000	0.8752516	437,626
Year 3 – first quarter	–	500,000	500,000	0.8426008	421,300
Year 3 – third quarter	–	500,000	500,000	0.8111681	405,584
Year 4 – first quarter	–	500,000	500,000	0.7809079	390,454
Year 4 – third quarter	–	500,000	500,000	0.7517765	375,888
Year 5 – first quarter	–	500,000	500,000	0.7237319	361,866
Year 5 – third quarter	10,000,000	500,000	10,500,000	0.6967335	7,315,702
			15,000,000		11,125,700

This fair value of £11,125,700 is inflated by the fact that £250,000 of accrued interest remains to be paid on the bond at 31 March 20XX (and which has effectively been recognised in the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement for 20XX/YY). The authority works with the 'clean' price for the bond by deducting the accrual, to give £10,875,700.

The movement in fair value to be recognised at 31 March 20XX is given by a comparison of the amortised cost of £10,777,322 recorded in the working papers and the clean price for the bond of £10,875,700 – a gain of £98,378.

The gain is accounted for as follows:

Dr Investments	£98,378
Cr Available-for-Sale Reserve	£98,378

The overall movement in the investment over the first three months of the holding is summarised as follows:

At 1 January 20XX – fair value (inclusive of premium)	£10,811,100
Accrued interest (reflected in fair value)	£250,000
Amortisation of premium	(£33,778)
Fair value adjustment – gain	£98,378
At 31 March 20XX – fair value	£11,125,700

The change in fair value since the acquisition date of £314,600 has been recognised as follows:

Cr Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement	£216,222
Cr Available-for-Sale Reserve	£98,378

Assuming that there are no further movements in prevailing interest rates over the remaining four-and-a-quarter years, the fair value of the bond reflected in the market price will move by the following processes:

- Increase by the amount of any interest accrued in the Surplus or Deficit on the Provision of Services (per the original schedule).
- Decrease by the amortisation of the premium paid in the Surplus or Deficit on the Provision of Services (these first two movements will be effected by crediting interest income to the Surplus or Deficit on the Provision of Services based on the original effective interest rate of 4% semi-annually applied to the original schedule of movements in amortised cost).
- Decrease by the actual receipt of interest (Dr Cash, Cr Investments).
- Decrease as the gain arising from the interest rate differential is consumed as the remaining period to the maturity date reduces to zero (Dr Available-for-Sale Reserve, Cr Investments) – the £98,378 recognised as a gain when prevailing interest rates moved will only be realised if the bond is sold; otherwise the credit in the reserve will fall over time and as payments are received by the authority (based on discounting remaining future cash flows at 7.75%).

C16 The following example shows the process of accounting for income and movements in fair value for a financial asset that does not have fixed or determinable payments.

ILLUSTRATION: FAIR VALUE ACCOUNTING FOR AN AVAILABLE-FOR-SALE FINANCIAL ASSET – NO DETERMINABLE PAYMENTS

During 20XX/YY, Harhooe Council paid £1m to buy a shareholding in OggPogg Transport Solutions. The company announces a dividend of £130,000 in January 20YY and makes a payment in February 20YY. At the end of 20XX/YY the shareholding is valued at £1,090,000. The council sells the shareholding for £1,250,000 in 20YY/ZZ.

The acquisition of the shareholding will be accounted for by:

Dr Investments	£1,000,000
Cr Cash	£1,000,000

On the basis that the dividend is announced before the share goes ex-dividend (ie the rights to receive a dividend remain with the seller of the shares), the fair value will increase by the dividend payable:

Dr Investments	£130,000
Cr Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure	£130,000

When the share goes ex-dividend and it is confirmed that the council will receive the dividend payment, the fair value falls again:

Dr Debtor – dividend receivable	£130,000
Cr Investments	£130,000

When the dividend is paid, the transaction is recorded as:

Dr Cash	£130,000
Cr Debtor – dividend receivable	£130,000

These transactions will result in no net movement to the value of the shareholding in the Balance Sheet. The change in fair value to £1,090,000 at the end of 20XX/YY is therefore recognised as a revaluation gain over the original purchase price of £1,000,000:

Dr Investments	£90,000
Cr Available-for-Sale Reserve	£90,000

As the shares are sold in 20YY/ZZ, the gain on sale is processed as follows:

Dr Cash	£1,250,000
Cr Investments	£1,090,000
Cr Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure	£250,000
Dr Available-for-Sale Reserve	£90,000

Authorities in England and Wales will also need to consider the capital financing implications of transactions in shares as the Prudential Framework defines the acquisition of share capital (in England) and share and loan capital (in Wales) as capital expenditure (and requires their disposal to be recognised as generating capital receipts) – see paragraphs C23 to C26. Scottish authorities which utilised a 'consent to borrow' to support share transactions should also consider the Prudential Framework implications.

Fair Value for Available-for-Sale Financial Assets

C17 For most available-for-sale assets, fair value will be straightforward to obtain, as there will be a reliable market price to refer to. However, valuation will be more problematic where, for example, an authority has equity shares in a private company that is not quoted on any stock exchange. The Code establishes a three-level hierarchy for arriving at valuations:

- **Active market: quoted market price** – if quoted prices are available, then authorities are required to use them. For many instruments there will be a single quoted price. Where the market for an instrument is brokered and two prices are quoted, the 'bid' price should be applied (the price that a dealer would be willing to pay for an instrument), as opposed to the 'ask' or 'offer' price (the price at which a dealer would be willing to sell an instrument) or the 'mid-market' amount (the average of the two prices). The price paid by the authority for an instrument will have been the (higher) offer price and the first valuation to the bid price might result in a loss being recognised for the difference. No account should be taken of any 'blockage' factors – the fact that a higher price might be obtained from selling a holding of a block of instruments (eg 51% of the shares in a company) as opposed to a single instrument.
- **No active market: valuation techniques** – if there is no market for the asset that is active at the Balance Sheet date, then a reliable valuation technique should be applied (see the following paragraph).
- **No active market: equity instruments** – if the application of all relevant valuation techniques produces a significant range of reasonable fair value estimates such that no valuation would be reliable, the instrument is exempted from fair value measurement (see paragraph C20).

C18 The objective of using a valuation technique is to estimate the price that could be obtained at the Balance Sheet date in an arm's-length exchange motivated by normal business considerations. Valuation techniques vary in complexity and expert help might be required in arriving at a value for some of the investments that an authority might hold. For some instruments, valuation will require the exercise of a significant amount of judgement. Authorities will need to ensure that the person making that judgement has the appropriate

knowledge and experience to make reliable assumptions about the risks and returns relating to the instrument.

C19 The range of techniques available where there is no quoted price at the Balance Sheet date includes:

- Taking the price for the most recent transaction involving the instrument that can be identified and adjusting it for changes in conditions since the transaction date, such as movements in the risk-free interest rate (eg the rate on government gilts).
- Using price information for instruments that are similar, adjusting for the effect of differences. Instruments will be substantially the same where the amount and timing of cash flows (including the maturity date) are comparable and the credit risk rating (and the factors on which changes in the rating are dependent) are the same.
- Applying present value techniques to the future cash flows expected to be generated by the instrument. Cash flows and discount rates should aim to reflect factors that are specific to the instrument being measured, reflecting assumptions that a market participant would use in setting a price, with any risk premium representing compensation for bearing the uncertainty inherent in cash flows being reflected in either the cash flow estimates or the discount rate.
- Using option pricing models – these are financial models that aim to calculate the price of an instrument as an option that might be called. For example, an unquoted equity share could be treated as a call option on the entity's assets, with the exercise price being the value of the entity's debt; the model would then analyse the cash flows that could be assumed for such a portfolio.
- In many practical instances, it will be acceptable to value investments in unlisted companies using the shareholders' equity identified in the company's latest audited Balance Sheet, adjusted where necessary by an assessment of the effect of future trading prospects and other factors on company profitability.

C20 There are two exceptions to the valuation principles:

- Short-term receivables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.
- Where fair value cannot be measured reliably (because the range of reasonable estimates is significant or the probabilities of the various estimates cannot reasonably be assessed), then the instrument must be carried at cost less impairment. The exemption does not take the instrument outside the scope of available-for-sale assets and it is particularly important that impairment is considered comprehensively and accounted for appropriately. Income arising from these assets (such as dividends) will be recognised as the right to receive payment is established.

Impairment of Available-for-Sale Financial Assets

C21 The expected approach to assessing whether impairment of available-for-sale financial assets has taken place is set out in paragraphs C27 to C32. In addition to the evidence of impairment set out in paragraph C29, a significant or prolonged decline in the fair value of an equity instrument will provide evidence of impairment. Impairment only occurs where the

fair value falls below the acquisition cost (net of any principal repayment and amortisation), even if there appears to be evidence of impairment as set out in paragraph C29.

Where there is an impairment loss:

- The carrying amount of the asset in the Balance Sheet is reduced to the current fair value.
- The loss charged to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement is calculated as the difference between the acquisition cost of the asset (net of any principal payments and amortisation) and the current fair value, less any impairment losses already charged to the Surplus or Deficit on the Provision of Services.
- Where there is a cumulative net loss accounted for in the Available-for-Sale Reserve, the charge to the Surplus or Deficit on the Provision of Services will partly be accounted for by posting this cumulative net loss out of the reserve (the balance of the Surplus or Deficit on the Provision of Services comprising the amount by which the carrying amount of the investment is written down).
- Recycling of any amount on the Available-for-Sale Reserve to the Surplus or Deficit on the Provision of Services will result in a mismatch between Other Comprehensive Income and the Balance Sheet. Recycled amounts should then be deducted as an additional item from Other Comprehensive Income and Expenditure to avoid overstating gains for the year.
- Interest income over the remaining term of the instrument is recognised by applying the rate of interest used in calculating the estimated recoverable amount (ie a prevailing market rate for a fixed rate instrument and the current variable rate under the contract for a variable rate instrument) (this credit is designed to unwind the discounting recognised in the impairment calculation).
- Where impairment losses have been recognised for an available-for-sale asset, all subsequent losses incurred on the asset should be posted to the Surplus or Deficit on the Provision of Services rather than the Available-for-Sale Reserve.
- If an impairment loss is subsequently reduced (eg because the borrower recovers from financial difficulties) and the decrease can be identified to an event that took place after the impairment was recognised, the impairment loss should:
  - not be reversed in the Surplus or Deficit on the Provision of Services for equity instruments – the uplift should be taken to the Available-for-Sale Reserve and recognised in Other Comprehensive Income and Expenditure
  - be reversed in the Surplus or Deficit on the Provision of Services for debt instruments – the uplift is limited to the amount of the amortised cost that would have been effective at the date of the reversal if the impairment had not been made.
- For available-for-sale assets carried at cost because fair value cannot be measured, impairment losses arise where there is a difference between the carrying amount (cost less any previously recognised impairments) and the present value of estimated future cash flows, discounted at the current market rate for a similar asset – losses are charged to the Surplus or Deficit on the Provision of Services and are not reversible.

C22 The following example shows how an impairment will affect the accounting treatment of an available-for-sale financial asset.

ILLUSTRATION: IMPAIRMENT OF AN AVAILABLE-FOR-SALE FINANCIAL ASSET

On 1 April 20PP, Wottingers Council purchased a £1m five-year bond with semi-annual interest of 5% payable on 30 September and 31 March. The price paid was £1,081,110, reflecting a bond premium of £81,110. The effective interest rate is 8% (4% on a semi-annual basis).

The council received both payments of interest due in 20PP/QQ and 20QQ/RR. After two years, on 31 March 20RR, the amortised cost of the asset was £1,052,422. Owing to adverse movements in market rates, the fair value of the bond had fallen by £26,632 – the reduction in the carrying amount of the asset has been balanced by a debit to the Available-for-Sale Reserve.

The issuer of the bond fell into financial difficulties and has not made the September 20RR and March 20SS payments. Following discussions with the issuer, the council decides that the bond has become impaired, with the best estimate of future cash flows being a £200,000 payment on 31 March 20TT and a final settlement of £700,000 on 31 March 20UU, the scheduled maturity date.

Although the bond is 'non-performing', the council is required under the effective interest rate methodology to account for the interest income for the year to 31 March 20SS. On this basis, the amortised cost of the bond at the bond is £1,138,300.

In order to calculate the impairment loss, the council needs to make a comparison against fair value. As the bond has fixed payments, the market price can be derived by calculating the fair value at 31 March 20SS, by discounting the expected cash flows at the current market rate. The council's treasury management advisers report that, when the bond was taken out, the risk-free rate for a debt instrument with similar terms was 7%. The bond's 8% rate therefore reflected a credit risk premium of 100 basis points. At 31 March 20SS, the risk-free rate is now 9%. Adding the 100 basis points to this rate gives a rate of 10% against which to discount the estimated cash flows over the remaining term of the bond. This results in a fair value of £760,330 for the projected receipts of £200,000 and £700,000 – £181,818 and £578,512 after discounting at 10% for one year and two years respectively. (Because of the change in the pattern of cash flows, discounting is on an annual basis, rather than the semi-annual basis used previously in the example.)

The impairment loss to be recognised in the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement is therefore:

	£
Amortised cost at 31 March 20RR	1,052,422
Accrual of half-yearly interest income to 30 September 20RR @ 4%	42,097
	1,094,519
Accrual of half-yearly interest income to 31 March 20SS @ 4%	43,781
Amortised cost at 31 March 20SS	1,138,300
Fair value of bond at 31 March 20SS	(760,330)
	377,970
Recycling of loss already recognised in the Available-for-Sale Reserve	26,632
Impairment loss recognised in the Surplus or Deficit on the Provision of Services	404,602

On the basis that the bond is currently being carried at £1,111,668 (the amortised cost of £1,138,300 less losses of £26,632 taken to the Available-for-Sale Reserve), the accounting entries on 31 March 20SS will be:

Dr	Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure	£377,970
Cr	Available-for-Sale Investments	£377,970
Dr	Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure	£26,632
Cr	Available-for-Sale Reserve	£26,632

Regulations and Statutory Guidance on Available-for-Sale Financial Assets

C23 At the time that these Guidance Notes were being prepared for publication, there were no specific statutory provisions that supersede the accounting arrangements for available-for-sale financial assets. In particular, the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement will be credited with interest income from bonds influenced by the amortisation of premiums and discounts built into the purchase price rather than the interest payable in the year.

C24 There may be a complication in England and Wales, where the acquisition and disposal of share capital in England and share and loan capital in Wales is brought within the scope of the capital controls framework. For share capital the arrangements are relatively straightforward, with the capital financing transactions being supplementary to the treatment of the shares as financial instruments:

- the acquisition of the shares will require incorporating into capital financing arrangements – revenue or capital receipts being set aside, or the payment being added to the Capital Financing Requirement to generate Minimum Revenue Provision
- dividends will be credited to the Surplus or Deficit on the Provision of Services as revenue income
- any proceeds generated by a sale will be capital receipts – the gain/loss on sale will be passed through the Surplus or Deficit on the Provision of Services with the capital receipts being recognised by a transfer from the Movement in Reserves Statement and the writing out of the investment balance.

C25 The situation with loan capital might be more complex as premiums and discounts involved in the purchase of corporate bonds are required to be passed through the Surplus or Deficit on the Provision of Services rather than treated simply as Balance Sheet transactions. Using the example of the bond in paragraph C15, the interest payable by the issuer of the bond is £250,000 for the first quarter that the bond is held. However, the credit to the Surplus or Deficit on the Provision of Services is £216,222 for interest income, reflecting the amortisation of the premium paid to acquire the £10m bond for £10.8m. Over the life of the bond, the amortisation of the bond will accelerate, further reducing the interest income recognised in the Surplus or Deficit on the Provision of Services. Previous practice would have been to credit the Income and Expenditure Account with £250,000.

C26 The appropriate treatment is better understood with a simpler illustration looking at the accounting entries over the whole life of a bond.

ILLUSTRATION: CAPITAL CONTROLS – IMPLICATIONS OF A CORPORATE BOND (WALES AND ENGLAND[4])

Aggerpang Council acquired a £1m bond for £1.2m. Over the term of the bond, £0.5m interest was receivable. The cumulative transactions over the life of the bond will therefore be:

Dr	Available-for-Sale Investment	£1,200,000
Cr	Cash	£1,200,000
Acquisition of the bond		
Dr	Available-for-Sale Investment (interest accrual)	£500,000
Cr	Available-for-Sale Investment (premium)	£200,000
Cr	Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure	£300,000
Recognition of interest income and the impact of the accrual on fair value		
Dr	Cash	£500,000
Cr	Available-for-Sale Investment (interest received)	£500,000
Actual receipt of interest reducing fair value		
Dr	Cash	£1,000,000
Cr	Available-for-Sale Investment	£1,000,000
Repayment of bond on maturity		

When deciding the capital financing treatment of these transactions, reference has to be made to the form of the statutory provisions in the Local Government Act 2003, regulations made thereunder and the statutory guidance on MRP, not to the substance of the transactions.

The relevant regulations for Wales (and previously in England prior to 1 April 2012*) prescribe that outlay on the acquisition of loan capital is capital expenditure, even though the making of an investment would not otherwise constitute expenditure under the Code. Provided that an authority considers corporate bonds as loan capital (the regulations do not give a definition of what falls within this description), then the acquisition cost is capital expenditure (which will give rise to MRP charges if capital receipts are not set aside, made over a maximum period of 20 years per the statutory guidance) and a capital receipt will arise when the authority is the other party to a transaction in which an interest in the corporate bond is acquired. It is arguable that this does not happen until the maturity date – the formal payment of interest (even though at a higher rate than the market) does not lead to any reduction in the cash flows due to the authority over the remaining term and no future rights have been limited by the payment. Furthermore, as the net credit of interest income includes an amortisation of the £200,000 premium, which has been met from capital resources, the amortisation should be treated in the same way as depreciation – ie reversed out of the General Fund Balance in the Movement in Reserves Statement (similarly, any impairment of an investment which has been funded from capital resources should be reversed out of the General Fund Balance in the Movement in Reserves Statement). The cumulative capital financing entries would then be (in this example the purchase being covered by capital receipts):

Dr	Capital Receipts	£1,200,000
Cr	Capital Adjustment Account	£1,200,000
Financing the acquisition of the bond		

4. For loan capital acquired prior to 1 April 2012.

Dr	Capital Adjustment Account	£200,000
Cr	General Fund Balance	£200,000
Reversal of premium amortised to the Surplus or Deficit on the Provision of Services to avoid double-charging for expenditure already financed from capital resources (via the Movement in Reserves Statement)		
Dr	Capital Adjustment Account	£1,000,000
Cr	Capital Receipts	£1,000,000
To register the receipt on maturity as a capital receipt		

*In England from 1 April 2012, the relevant regulations prescribe that the acquisition of loan capital of individual companies is not capital expenditure. However, if a bond was acquired prior to 1 April 2012 and was counted as capital expenditure, the proceeds are to be treated as capital receipts.

Impairment and Uncollectability of Financial Assets

C27 The Code sets out detailed provisions requiring the assessment of impairment for financial assets. These provisions are intended to lead to the identification of situations where a risk has arisen that contracted payments might not take place, rather than where there have been changes in underlying economic conditions, such as prevailing market interest rates.

C28 An asset will only be accounted for as impaired where:

- There is evidence of impairment (see paragraph C29).
- The evidence is objective – for example, the downgrading of a creditor's credit rating will be a subjective decision by the rating entity unless other available information confirms that the move is appropriate (it might also be based on future probabilities – see next bullet).
- Impairment is attributable to a past event that occurred subsequent to the initial recognition of the asset – no matter how likely it might become that an event will take place that will reduce the value of a financial asset, it is not reflected in an impairment loss until it has taken place. Even though impairment is allowed under certain circumstances to be assessed on a group basis (see paragraph C31), this still requires observable data indicating that there is a measurable decrease in the estimated future cash flows from the group of assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group.

C29 Paragraph 7.3.3.1 of the Code lists a number of events that would provide objective evidence of impairment:

- Significant financial difficulty of the creditor – in this context 'significant' could be taken as meaning that there is a substantial risk that the difficulties will result in payments due under the instrument not being made.
- A breach of contract, such as a default or delinquency in interest or principal payments.
- The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would otherwise not consider – for example, an authority might agree to receive a reduction in interest payments in order to forestall a breach of contract by the borrower due to insolvency.

- It becoming probable that the borrower will enter bankruptcy or other financial reorganisation (provided that this probability is based on past events).
- The disappearance of an active market for the particular financial asset because of financial difficulties.
- Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
  - adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments), or
  - national or local economic conditions that correlate with defaults on the assets in the group (eg a significant increase in the unemployment rate in the authority's area).

A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

C30 At each Balance Sheet date authorities need to make a two-stage assessment as to whether impairment losses needed to be recognised:

- firstly, whether there is evidence of impairment for individual assets that are significant, and
- secondly, whether there is evidence of impairment for groups of similar assets.

C31 The collective assessment of groups of assets should exclude assets that have been impaired individually. The process will be:

- Group assets on the basis of similar risk characteristics – the risks used should be relevant to the estimation of future cash flows, being indicative of the borrowers' ability to pay all amounts due under the contractual terms. Relevant bases for grouping might be the type of contract (eg trade debtors, unsecured loans made for economic development, etc) and past-due status (eg age analysis of a debtor balance).
- Assess future cash flows for the group – an estimate should be made of the extent to which cash flows will not take place in accordance with contractual conditions, based on historical loss experience for assets with credit risk characteristics similar to those in the group. Where historical loss experience does not properly reflect current conditions, appropriate adjustments should be made to reflect changes in conditions in the historical loss experience.

C32 The measurement of impairment losses and the reversibility of losses differ between the different types of financial assets. These are discussed in the sections on the individual asset types:

- loans and receivables – paragraphs C9 and C10
- available-for-sale assets – paragraphs C21 and C22
- available-for-sale assets carried at cost – paragraph C21.

Derecognition of a Financial Asset

C33 For most financial assets, derecognition will be straightforward. Derecognition will occur at the point that contractual rights to the cash flows arising from the instrument expire or are transferred. The accounting treatment will depend on the asset type.

Loans and receivables	Where the instrument is held to maturity, the final payment of principal and interest will bring the amortised cost of the asset carried in the Balance Sheet down to zero. If there is any positive or negative balance left in relation to the asset, perhaps because the lender has paid a penalty to repay early or the authority has waived some of the payment due, this balance will be written off to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement as a gain/loss. For example, if an authority has lent £200,000 to a voluntary organisation at fixed interest rates with the principal repayable on maturity and the authority decides to require only £100,000 in final settlement, the entries would be: Dr Cash £100,000 Dr Comprehensive Income and Expenditure Statement – relevant service revenue account £100,000 Cr Investments £200,000 (In this case, the debit is made to a service as the concession is effectively grant aid for the voluntary organisation.)
Available-for-sale assets	As the instrument has been carried at fair value, then it might be the case that the final payment upon the expiry or termination of the contract will write the balance of the asset down to zero. Where there is any difference, perhaps because of estimates used in the valuation, the difference will be written out to the Surplus or Deficit on the Provision of Services in the Comprehensive Income and Expenditure Statement as a gain/loss. Upon derecognition, any balance on the Available-for-Sale Reserve should be recycled through the Surplus or Deficit on the Provision of Services. For example, if an authority bought a shareholding for £500,000, had revalued it to £700,000, but sold it for £690,000, the entries would be: Dr Cash £690,000 Cr Investments £700,000 Cr Comprehensive Income and Expenditure Statement – Financing and Investment Income and Expenditure £190,000 Dr Available-for-Sale Reserve £200,000 (Recycling of any amount on the Reserve to the Surplus or Deficit on the Provision of Services will result in a mismatch between Other Comprehensive Income and Expenditure and the Movement in Reserves Statement. Recycled amounts should therefore be deducted as an additional item from the Other Comprehensive Income and Expenditure to avoid overstating gains for the year.)
Available-for-sale assets carried at cost	As it has been impossible to arrive at a value for the asset over its life, it could be the case that any proceeds generated on the disposal of the asset are substantially different from the carrying amount based on cost. Any difference is written out to the Surplus or Deficit on the Provision of Services.

C34 Complications would arise on derecognition where an authority transfers an asset to another party but retains an interest in the asset. An example from the private sector would be where an instrument is sold to a buyer who has the unconditional right to return the asset at the original price (usually with interest). These arrangements need to be examined in detail to determine whether the financial asset should be retained on the Balance Sheet and whether any monies received are sale proceeds or secured borrowings. It is not expected that local authorities will have entered into transfer arrangements like this and the Code does not set out any accounting provisions in relation to them. In the exceptional event that authorities have entered into such transactions, they will need to make reference to the detailed provisions of IAS 39, paragraphs 15 to 37 and AG36 to AG52.

D DISCLOSURE AND PRESENTATION REQUIREMENTS

Please see the following section of the Code

Section 7.4

D1 The Code requires extensive disclosures in relation to financial instruments which should enable users to evaluate:

- The significance of financial instruments for the authority's financial position and performance. This is done by making disclosures in the Balance Sheet, the Comprehensive Income and Expenditure Statement and the notes to the accounts.
- The nature and extent of risks arising from financial instruments to which the authority was exposed and how the authority manages those risks – the requirement is to provide notes to the accounts that explain the authority's exposure and its policies and make a quantitative assessment of exposure.

In these disclosures, authorities should aim to present a strategic and balanced summary of the most significant risks and management arrangements in relation to financial instruments. This should be consistent with the authority's treasury management strategy, treasury management practices and the prudential indicators for treasury management. It would be helpful to include a statement that the authority has adopted CIPFA's *Treasury Management in the Public Services: Code of Practice* and that it has set treasury management indicators to control key financial instrument risks.

D2 Illustrations of the disclosures required by the Code are provided in the example Statement of Accounts appended to Module 3 of these Guidance Notes.

D3 The Code gives some discretion to authorities in determining how they meet its requirements:

- The detail included will depend on the extent of the authority's involvement in financial instruments, in terms of the amounts recorded in the Balance Sheet and the range and complexity of the loans, investments and other instruments to which it is a party: an authority with only PWLB loans and some cash on deposit will have a limited amount to disclose, but an authority with LOBOs, shareholdings, corporate bonds, etc will need to make more extensive disclosures.

- Some information can be disclosed either on the face of the Balance Sheet or Comprehensive Income and Expenditure Statement or in the notes, leaving authorities to determine how much prominence is needed to be given to these transactions and balances. The Code states that it is unnecessary to repeat information that is on the face of a financial statement in the notes.
- In certain cases, the authority's position could be explained through either narrative detail or quantified data. Discretion should be applied in each case to determining what the most appropriate balance is for the authority's circumstances.
- Where an authority is party to a group of financial instruments with similar characteristics and no single contract is material, disclosure can be made in summary for that class of instruments.

D4 The overall task will be to balance the risk of overburdening the financial statements with excessive information that will obstruct the typical user's appreciation of the authority's position and performance against the possibility that key information is either omitted or unidentifiable because aggregation is at too high a level.

D5 This means that the example disclosures that are provided in the Example Statement of Accounts (see Module 3) should be considered critically because the balance of information provided might be inappropriate to individual circumstances. **It is important to note that these disclosures should not be regarded as the minimum requirements needed to satisfy the Code**.

Disclosure Requirements

Significance of Financial Instruments for Financial Position and Performance

Balance Sheet

D6 Paragraph 7.4.2.2 of the Code requires that the carrying amounts of each of the following shall be disclosed either in the Balance Sheet or in the notes to the accounts:

- loans and receivables (note that where material the Code now requires that the amount of soft loans granted by the authority be disclosed separately (see below))
- available-for-sale financial assets
- unquoted equity investment at cost
- financial assets at fair value through profit or loss (if any)
- financial liabilities at amortised cost
- financial liabilities at fair value through profit or loss (if any).

Where an authority is required to separately disclose the carrying amount of soft loans granted, the Code requires that it must also disclose:

a) a reconciliation between the opening and closing carrying amounts of the soft loans, including:

   i) nominal value of new loans granted during the period

   ii) the fair value adjustment on initial recognition

iii) loans repaid during the period

iv) impairment losses recognised

v) any increase during the period in the discounted amount arising from the passage of time, and

vi) other changes

b) nominal value of the loans at the end of the period

c) the purpose and terms of the various types of loans, and

d) valuation assumptions.

D7 Where the Balance Sheet or notes show unusual movements, consideration should be given to whether additional information needs to be provided to explain the movements (or a cross-reference to an explanation elsewhere in the accounts).

D8 There is no requirement to produce a comprehensive note reconciling the movements on borrowings and investments to events such as acquisition, revaluation, amortisation and disposal. However, notes are needed if particular events have taken place that have a material effect:

Event	Requirements	Guidance
Reclassification	Where the authority has reclassified a financial asset either way between a category measured at cost/amortised cost and one measured at fair value, a note is needed of the amounts involved and the reason for the reclassification.	As the Code does not give authorities any discretion in classifying financial assets, reclassification will only be applicable where a limited range of events take place: ■ an asset with fixed or determinable payments either ceases to be or starts to be quoted in an active market ■ it becomes or ceases to be possible to establish a reliable fair value for an equity investment.
Offsetting financial assets and financial liabilities	Where the authority has offset financial assets and financial liabilities in accordance with the criteria for offsetting financial assets and liabilities – see paragraph D30 below (see also paragraph 7.4.5.1 of the Code), the Code requires that the detailed disclosures specified by paragraph 7.4.2.4 of the Code are made. These disclosures also apply to recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are set off in accordance with paragraph D30.	Where offsetting of financial assets and financial liabilities takes place in an authority, the Code requires that information is provided that will enable users of the financial statements to evaluate the effect or potential effect of netting arrangements, including rights of set-off associated with the authority's recognised financial assets and financial liabilities on the authority's Balance Sheet.

Event	Requirements	Guidance
Collateral	Where the authority has pledged collateral for liabilities or contingent liabilities, a note is needed of: ■ the carrying amount of the financial assets pledged ■ the terms and conditions relating to the pledge. (See IFRS 7, paragraph 14.) Where the authority holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral even if there has been no default, disclosure is required of: ■ the fair value of the collateral held ■ the fair value of any such collateral sold or repledged (and whether the authority has an obligation to return it) ■ the terms and conditions associated with the authority's use of the collateral.	Authorities do not normally pledge collateral. Where collateral has been pledged or the authority has received a pledge, such transactions will be exceptional and should thus be easily identifiable within the authority's treasury management transactions.
Allowance account for credit losses	Where financial assets have been impaired by credit losses and the credit entry has been made in an allowance account rather than against the carrying amount of the asset, a reconciliation of the change in the balance on the allowance account during the year, analysed for each class of asset.	Use of an allowance account permits an authority to continue to record an asset at amortised cost, with an offsetting balance shown separately in the Balance Sheet. As a discretionary accounting treatment, it should be clear when the authority has used such an account.
Defaults and breaches	For loans recognised under financial liabilities: ■ details of any defaults of payments due under the contract ■ the carrying amount of the loans in default at 31 March ■ whether the default was remedied (or the contractual terms renegotiated) before the financial statements were authorised for issue.	It will be exceptional for an authority to default on a loan – again, any such event should be straightforward to identify.

D9 The Code requires information about amounts that have been charged to the Comprehensive Income and Expenditure Statement:

a) The net gain/loss on:

i) financial assets or financial liabilities at fair value through profit and loss (if any)

ii) available-for-sale financial assets, showing the amount recognised in Other

Comprehensive Income and Expenditure and any amounts reclassified from Other Comprehensive Income and Expenditure to the Surplus of Deficit on the Provision of Services for the year

iii) loans and receivables

iv) financial liabilities measured at amortised cost.

b) Total interest income and total interest expense (calculated using the effective interest rate method) for financial assets or financial liabilities that are not at fair value through profit and loss.

c) Fee income and expense (other than amounts included in determining the effective interest rate) arising from:

i) financial assets or financial liabilities that are not at fair value through profit or loss

ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

d) Interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39.

e) The amount of any impairment loss for each class of financial asset.

D10 Where the authority does not have complex holdings of financial instruments, these requirements could be satisfied by a single note that details all gains and losses arising in the year and where they have been posted.

Accounting Policies

D11 The Code specifies particular accounting policies that must be disclosed where the authority has material relevant transactions and balances, ie the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Fair Value

D12 For each class of financial assets and financial liabilities, an authority is required to disclose the fair value of that class of assets and liabilities in such a way that a comparison with the carrying amount is possible.

D13 In disclosing fair values, the authority should group financial assets and liabilities into classes but should only offset them to the extent that their carrying amounts are offset in the Balance Sheet (paragraph 7.4.2.12 of the Code).

D14 The fair value disclosures required are:

- For each class of financial instruments measured at fair value, an authority should disclose the methods used and, when a valuation technique is used, the assumptions applied in determining the fair values for each class of financial asset or financial liability. For example, if applicable an authority will disclose information about assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. If there has been a change in valuation technique, an authority shall disclose this change and the reason for making it.

- The authority should also disclose whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique. An authority should therefore set out whether and when carrying amounts are determined from quoted market prices, independent appraisals, discounted cash flow analysis or other appropriate method.

D15 The Code requires the following additional disclosures in relation to fair value:

- Whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (ie without modification or repackaging) and not based on available observable market data. For fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the authority shall state this fact and disclose the effect of those changes. For this purpose, significance shall be judged with respect to surplus or deficit on the provision of services, and total assets or total liabilities, or, when changes in fair value are recognised in equity, total equity.
- If the bullet above applies, the total amount of the change in fair value estimated using such a valuation technique that was recognised in surplus or deficit on the provision of services during the period.

D16 Example notes covering these requirements are included in the Example Statement of Accounts in Module 3.

D17 The fair value disclosure is required even where carrying amounts are not materially different from fair value, in order to confirm that this is the case. However, there are three specific exemptions from disclosures in relation to:

- instruments where the carrying amount will be a reasonable approximation of fair value (eg short-term trade receivables and payables)
- investments in equity instruments that do not have a quoted market price
- for a contract containing a discretionary participation feature (as described in IFRS 4 *Insurance Contracts*), if the fair value of that feature cannot be measured reliably.

D18 For the second and third bullets above instead of providing a figure for fair value, authorities are required to disclose:

- the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably
- a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably
- information about the market for the instruments
- information about whether and how the authority intends to dispose of the financial instruments, and
- if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amounts at the time of derecognition, and the amount of gain or loss recognised.

D19 In meeting the fair value requirements, it is recommended that the note is subdivided in such a way that carrying amounts can be identified to balances in the Balance Sheet or in the notes to the accounts.

D20 If the market for a financial instrument is not active, local authorities would need to establish its fair value using appropriate valuation techniques. Valuation techniques would include using recent arm's-length market transactions between knowledgeable and willing parties if available, reference to the (fair) valuation of another instrument which is substantially the same, discounted cash flow techniques or option pricing models. The Code notes that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an authority shall disclose, by class of financial instrument:

- its accounting policy for recognising the difference in surplus or deficit to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph AG76A of IAS 39), and
- the aggregate difference yet to be recognised in the Surplus or Deficit at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

Nature and Extent of Risks Arising from Financial Instruments

D21 The Code following IFRS 7 has very detailed requirements for disclosures about the risks to which the authority is exposed in its dealings with financial instruments and how they have been managed. The main risks covered are:

- **credit risk** – the possibility that one party to a financial instrument will fail to meet their contractual obligations, causing a loss for the other party
- **liquidity risk** – the possibility that a party will be unable to raise funds to meet its commitments associated with financial instruments
- **market risk** – the possibility that the value of an instrument will fluctuate because of changes in interest rates, market prices, foreign currency exchange rates, etc.

D22 The Code notes that providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments. The interaction between qualitative and quantitative disclosures contributes to disclosure of information in a way that better enables users to evaluate an authority's exposure to risks.

D23 It is not within the scope of the these Guidance Notes to discuss the range of objectives that an authority will need to have in place and the benchmarks that it will set in order to meet the disclosure requirements. These disclosures should measure the authority's objectives against good treasury management practices and Balance Sheet management practice for local authorities.

D24 The general requirements for the disclosures are as follows.

Qualitative disclosures	For each type of risk: ■ the authority's exposure to the risk and how it arises ■ its objectives, policies and processes for managing the risk and the methods used to measure the risk ■ any changes in exposure to risk and the authority's approach (previous two bullets) from the previous year.
Quantitative disclosures	For each type of risk: ■ summary quantitative data about its exposure to the risk at 31 March (based on information provided internally to key management personnel and members of the authority; the Code cites the example of the finance committee or chief executive, however this must relate to the particular circumstances of the authority) ■ concentrations of risk not apparent from the summary data in the previous bullet.

D25 The minimum detailed disclosures required for each risk are as follows.

	Disclosure	Guidance
Credit risk	By class of financial instrument: ■ the amount that best represents its maximum exposure to credit risk at the reporting date (without taking into account any collateral held or other credit enhancements) – this disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk ■ a description of collateral held as security and other credit enhancements and their financial effect (eg a quantification of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk ■ information about the credit quality of financial assets (excluding those that are either past due or impaired)	These disclosures seek to measure the possible impact on the authority of payments not being made in accordance with contractual terms. Relevant risks would include the possibility that a bank will not repay deposits, that a bond issuer will default on interest payments or that a company will default on a loan made to it. Reasonableness should be applied to the calculations, as the maximum exposure is otherwise that no future payments of any kind will be received. An assessment should be made using the authority's historical experience of credit risk, updated to reflect current market conditions.

	Disclosure	Guidance
Credit risk (continued)	For each class of financial assets that includes instruments that are either past due (payments due under the contract have not been made) or impaired: ■ an analysis of the age of financial assets that are past due at 31 March but are not impaired ■ an analysis of financial assets that are individually determined to be impaired at 31 March, including the factors the authority considered in determining they are impaired. Where the authority obtains financial or non-financial assets during the year by taking collateral it holds as security or calling on other credit enhancements (eg guarantees): ■ the nature and carrying amount of the assets obtained ■ when the assets are not readily convertible into cash, its policies for disposing of such assets or using them in its operations.	Authorities will have policies of generally only making investments in entities that have a credit rating of a prudent minimum score. However, circumstances will arise in the normal course of business where sums due are unpaid or loans with greater credit risk are made to advance service objectives (such as economic development). Where collateral is taken, fair value should be calculated in the same way as for a financial asset owned by the authority.
Liquidity risk	For financial liabilities: ■ a maturity analysis for financial liabilities that shows the remaining contractual maturities ■ a description of how the inherent maturity/liquidity risk is managed.	For an authority, the straightforward availability of borrowing means that liquidity risk is more likely to relate to exposure to replenishing a significant proportion of its borrowings at the rate prevailing at a particular maturity date, rather than the possibility that an authority will not have monies available to settle its liabilities on the due date. Authorities are free to choose the most appropriate time bands for the maturity analysis. Liabilities should be allocated to the time band when the counterparty could first require payment. This might require some analysis of the circumstances that are likeliest to pertain – for example, an assessment of the maturity date for a LOBO will require a prediction of the likelihood that the lender might give the authority an opportunity to repay at any option date and, if so, whether the authority would take up that option or whether the actual maturity date should be used.

	Disclosure	Guidance
Liquidity risk (continued)		The amounts disclosed should be the contractual undiscounted amounts (eg gross loan commitments and gross finance lease rentals) such that amounts are likely to differ from those in the Balance Sheet.
Market risk	For each type of market risk to which the authority is exposed: ■ a sensitivity analysis for each type of market risk to which the authority is exposed at 31 March, showing how the Surplus or Deficit on the Provision of Services and Other Comprehensive Income and Expenditure would have been affected by changes in the relevant risk variable that were reasonably possible at that date ■ the methods and assumptions used in preparing the sensitivity analysis ■ changes from the previous year in the methods and assumptions used (and the reasons for any changes).	There is no prescribed methodology for preparing a sensitivity analysis for the Statement of Accounts. The expectation of the Code is that authorities will have developed approaches for the treasury management strategy and budget setting that can be applied.

D26 Where an authority has no material exposure to one or more of the risk types, this fact should be disclosed rather than no comment being made in relation to that risk.

D27 It is not possible to set out a model disclosure note, as all authorities will have a unique profile of risks to which they might be exposed and measures that have been taken to minimise exposure in relation to the risks. The illustration in the Example Statement of Accounts in Module 3 needs to be regarded critically as to its applicability to local circumstances – it is not a template, but an example that will help practitioners consider their authority's own specific requirements. There is no exemption from the Code's general requirements for the inclusion of prior year comparative figures in the disclosure note. Authorities will need to consider whether comparatives will be helpful for each of the disclosures.

Transfers of Financial Assets

D28 The Code includes the IFRS 7 requirements in relation to disclosures of transfers of financial assets. Such transfers are described in part by paragraph C34 above and occur where an authority transfers a financial asset to another party but retains an interest in it. It is unlikely that local authorities will be involved in such transfers of financial assets to other parties which would require that the authority transfers the financial asset which may or may not be derecognised in its entirety but retains a continuing involvement in it. A transfer of a financial asset meets the requirements for disclosure in paragraph 7.4.4.1 of the Code if it:

- transfers the contractual rights to receive the cash flows of that financial asset, or

- retains the contractual rights to receive the cash flows of that financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement.

Where such transactions occur, paragraph 7.4.4.1 of the Code requires that the disclosures required by paragraphs 42B to 42H of IFRS 7 (per the amendments to IFRS 7 issued in October 2010) are included in a single note to the financial statements. These detailed disclosure requirements are aimed at demonstrating to the users of the financial statements the financial relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities and to enable them to evaluate the nature of, and risks associated with, the authority's continuing involvement (in the limited occasions that this might happen) in derecognised financial assets.

Presentation Requirements

Offsetting a Financial Asset and a Financial Liability

D29 The Code contains some particular provisions about presentation of information about financial assets and liabilities, deriving from IAS 32 *Financial Instruments: Presentation*[5] and from IAS 1 *Presentation of Financial Statements*.

D30 Financial assets and financial liabilities (and by implication their impact on such things as interest expenses) should be presented gross in the Statement of Accounts, unless:

- the authority has a legally enforceable right to set off the amounts – eg a contract provides that the authority can make a reduced payment of a sum due from a supplier in lieu of receiving payment for an amount the supplier owes the authority (when applying this criterion authorities shall also refer to paragraphs AG38A to AG38D of IAS 32 as amended in 2011),

  and

- the authority actually intends to settle on a net basis, or to realise the asset and settle the liability simultaneously (when applying this criterion authorities shall also refer to paragraphs AG38E to AG38F of IAS 32 as amended in 2011).

D31 If a local authority transfers an asset that does not qualify for asset derecognition under the financial instrument standards, then the asset should not be offset against the associated liability.

Current and Non-current Financial Liabilities

D32 The Code requires the Balance Sheet to present separately current and long-term liabilities in accordance with the requirements of IAS 1. Therefore the Code requires that an authority classify a financial liability as current when:

- It expects to settle the liability in its normal operating cycle.
- It holds the liability primarily for the purpose of trading.
- The liability is due to be settled within 12 months after the reporting period.

5. The 2014/15 Code includes the amendments to IAS 32 *Financial Instruments*: *Presentation (Offsetting Financial Assets and Liabilities)*, December 2011.

or

- The authority does not have an unconditional right to defer the settlement of the liability for at least 12 months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other financial liabilities must be classified as long-term liabilities.

D33 The Code would anticipate that separation should be applied to individual elements of financial instruments, such as interest payable and receivable and dividends receivable. For example, a £10m loan repayable by instalments which had accrued unpaid interest payable of £350,000 at the year-end and a £1m instalment of principal due in the next financial year would be presented as a current financial liability of £1.35m and a long-term financial liability of £9m. Even where separated, the assets and liabilities remain financial instrument balances and should be carried in the Balance Sheet as borrowings rather than as part of creditors.

D34 The Code clarifies that a financial liability should be presented as current when it is due to be repaid within 12 months of the Balance Sheet date even if:

- the original term was for a longer period than 12 months, and
- an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the Balance Sheet date and before the financial statements are authorised for issue.

D35 The Code provides additional guidance (adapted from guidance provided in IAS 1) where financial liabilities have been renegotiated or refinanced. Current or non-current classification is governed by the conditions at the Balance Sheet date. The Code provides two examples:

- When an undertaking under a loan agreement (such as the authority maintaining a specified minimum measure of solvency or credit worthiness) is breached on or before the Balance Sheet date with the effect that the liability becomes repayable on demand, the liability becomes current.
- If a liability under an existing loan facility is otherwise due to be settled within 12 months but the authority has the discretion to refinance or rollover an obligation for at least 12 months after the Balance Sheet date, the liability should be treated as non-current if the authority expects to exercise the discretion – without such a discretion, the potential to refinance is not considered and the liability will be current.

D36 The Code requires that the portion of long-term liabilities due to be settled within 12 months after the Balance Sheet date including accrued interest shall be disclosed separately from other current creditors in the notes to the accounts where not presented separately on the Balance Sheet.

Current and Non-current Financial Assets

D37 The Code requires a financial asset to be classified as current when an authority:

- expects to realise or sell it, in its normal operating cycle
- holds the financial asset primarily for the purpose of trading

- expects to realise the asset within 12 months after the reporting period, or
- the asset is cash or a cash equivalent (as defined in IAS 7).

All other financial assets must be classified as long-term financial assets.

D38 The Code clarifies that current financial assets include trade receivables that are realised as a part of the normal operating cycle even if they are not expected to be realised within 12 months of 31 March.

D39 Current assets also include some financial assets held primarily for the purpose of trading in accordance with IAS 39 and the current portion of non-current financial assets.

D40 The portion of long-term financial assets due to be realised within 12 months after the Balance Sheet date including accrued interest shall be disclosed separately from other current debtors in the notes to the accounts where not presented separately on the Balance Sheet.