THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

16 February 2007

Our ref: ICAEW Rep 07/07

Your ref:

The Secretary
CIPFA/LASAAC Joint Committee
c/o Policy and Technical Directorate
CIPFA
3 Robert Street
London WC2N 6RL

By email

Dear Sir

CODE OF PRACTICE ON LOCAL AUTHORITY ACCOUNTING 2007

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the Exposure Draft of a *Revised Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice 2007*, published in November 2006.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW Representation

ICAEW REP 07/07

CODE OF PRACTICE ON LOCAL AUTHORITY ACCOUNTING 2007

Memorandum of comment submitted in February 2007 by The Institute of Chartered Accountants in England and Wales, in response to CIPFA/LASAAC's Exposure Draft of a Revised *Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice 2007*, published in November 2006.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the Exposure Draft of a Revised *Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice 2007,* published by the CIPFA/LASAAC Joint Committee in November 2006.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

Support for the SORP

4. We welcome the revision of the SORP and in particular the new material on financial instruments. We generally concur with the approach adopted, with our only major exceptions being

   (a) in relation to soft loans, we do not agree with recognising a grant-in-aid prepayment asset (see paragraphs 13 - 17 below);

   (b) we do not agree with setting the opening balance on the Revaluation Reserve at 1 April 2007 at zero (see paragraphs 39 - 41 below).

RESPONSES TO SPECIFIC QUESTIONS

Financial Instruments

Q1: Do you agree that it would not be credible to leave the SORP financial instruments accounting requirements unchanged?

5. We agree. If local authorities do not adopt new standards they would have to go for full FRS 4 implementation to demonstrate compliance with UK GAAP.

Q2: Do you agree that the options for updating the financial instruments requirements of the SORP are:

(a) to base the new SORP requirements on the new standards for all authorities; or

(b) to base the new SORP requirements on the new standards only for authorities that are listed entities and to revise the SORP to deal much more comprehensively with financial instruments under the old standards for other authorities (with the probability that the SORP financial instruments requirements would need change again within a few years)?

6. We agree that these are the options and we favour option (a).

Q3: Do you agree that the SORP requirements for financial instruments should be based on the new financial instruments standards?

7. We agree. We would go further than the implication of the question, and suggest that the SORP's requirements should be fully compliant with the new financial instruments standards, and thus follow them rather than merely be based on them. We endorse the reasoning behind the Joint Committee's approach set out in the Invitation to Comment. We note further that with regard to the key issues of premiums and discounts there would be no substantive difference between the requirements of FRS 4 *Capital Instruments* and FRS 25 and 26.

Q4: Do you agree that:

(a) Local authorities do not normally hold financial instruments for trading or derivative financial instruments?

8. We agree that most authorities don't trade in financial instruments. However there are some authorities that engage in more active treasury management who may be considered to trading. We therefore suggest there should be a requirement for authorities to consider whether they are trading (rather than assuming they don't).

(b) The accounting requirements relating to financial instruments at fair value through profit or loss are best covered in an Annex rather than the main body of the chapter on financial instruments?

9. We agree. It would be helpful if the main body of the SORP conta ined better signposts to the material in the Annex.

(c) All authorities should account for similar transactions in a similar way and therefore the SORP should indicate how the discretions permitted generally to entities under FRS 26 should be exercised?

10. We agree. This would match the lack of discretion given to Central Government.

(d) Unless it was determined that a local authority held financial instruments for trading, the SORP should require financial instruments to be classified into one of the following three FRS 26 financial instrument categories:

- **Other financial liabilities (ie at amortised cost)**
- **Loans and receivables**
- **Available-for-sale financial assets?**

11. We agree.

(e) All authorities should use trade date accounting?

12. We agree.

Q5: Do you agree with the Joint Committee's preferred approach to soft loans of:

- **writing down all soft loans to fair value on initial recognition**
- **recognising a grant-in-aid prepayment asset for those soft loans which enhance the long-term capacity of the borrowing non-profit organisation to deliver its services**
- **immediately expensing the write down of other soft loans?**

13. We do not agree that a prepayment asset should be recognised, as we believe prepayments would normally fail to meet the definition of an asset on grounds of control. If the local authority were to retain control, then we believe that this would point to an agent/principal relationship. Immediate write-down against Income and Expenditure accords with UK GAAP, and we do not believe a departure similar in nature to amortising 'deferred charges', which was only recently removed from the SOP, is justified.

14. We accept that there may be a danger that local authorities might refrain from making soft loans to the Third Sector because of the accounting implications, and that there may consequently be a diversion of resources from 'additional' to 'core' services. It would be unfortunate if the accounting treatment were to drive economic decision-making. We trust that this problem will not arise once the draft regulations mitigating the effects of accounting for soft loans on a GAAP basis are implemented.

Q6: Do you agree with the Joint Committee's analysis of the circumstances in which it would be appropriate to recognise the write down to fair value of a soft loan as an asset?

15. We disagree. As noted above, where the local authority retains control we believe it will be acting as principal with the loan recipient in the role of agent. We also note that expenditure by a third party on an asset does not necessarily create an economic benefit for the authority. This is, in effect, similar to the position on deferred charges which it is now accepted should be written off to the I&E account.

Q7: If you do not agree (see Q6 above) do you consider that there are any circumstances in which it would be appropriate to recognise the write down to fair value as an asset? If so, please specify the circumstances.

16. We do not consider that there are any circumstances in which it would be appropriate to recognise the write down to fair value as an asset.

Q8: If you do not agree with the Joint Committee's preferred approach, which approach do you prefer, eg:

(a) initial recognition at fair value with the write down to fair value of all soft loans immediately expensed
(b) initial recognition at fair value with the write down of all loans carried on the balance sheet as a prepaid grant-in-aid
(c) initial recognition at the amount of the loan advanced
(d) another approach (please specify)?

17. For the reasons set out above, we favour option (a).

Q9: Do you agree with the ITC's interpretation (see Appendix 1 of the ITC) of how amortised cost using the effective interest rate would apply to the following types of transactions:

(a) a fixed rate bond purchased at a discount?
(b) a fixed rate loan debt carrying a rate of interest that is not the same for the whole term of the loan ('stepped')?
(c) a variable rate bond purchased at a premium?

Please comment individually on questions (a) to (c).

18. We agree with all three interpretations. We suggest that the SORP should make it clear that these are simply illustrations, and not exhaustive.

Q10: Do you agree with the ITC's interpretation of how a debt restructuring that is a modification of the terms of the old loan(s) should be accounted for? See Appendix 2 of the ITC.

19. We agree.

Q11: Do you agree with the ITC's interpretation of how a 'vanilla' LOBO loan should be accounted for? See Appendix 3 of the ITC.

20. We agree.

Q12: Do you agree with the ITC's interpretation of how a 'stepped' LOBO loan should be accounted for? See Appendix 3 of the ITC.

21. We agree. However, we suggest that in practice few of these loans will run to their maximum term, and that the lender may have established by means of a matched contract a much shorter period in which it expects to recoup its commercial margin. The Joint Committee may therefore wish to consider the extent to which its comment in paragraph 3 that the full term of the loan should be employed to determine the effective interest rate is justified. Where there is a matched contract it should be possible to determine the relevant period as that reflecting the length of time needed to recoup the discount offered in the first years of the arrangement. An alternative approach would be to calculate to next break point if this is the only certain date. We suggest that such approaches may in practice provide sufficiently reliable estimates of the life of the loan to meet the requirements of FRS 25.

Q13: Do you agree that the effective date for transition to the proposed new financial instrument requirements should be 1 April 2007?

22. We agree. However, we note that this will involve a major effort on the part of local authorities and may bring some significant changes to accounts.

Q14: Do you agree that recognition and derecognition of financial instruments before 1 April 2006 (eg carrying forward on the balance sheet a premium on early repayment of loan debt) should not be changed notwithstanding that the accounting treatment would have been different if the 2007 SORP financial instruments requirements had been in place at the time?

23. We agree. The primary objective is to ensure soundly-based financial statements going forward: dealing with the timing of the adjustment is not of major importance.

Q15: Do you agree that authorities should not be required to restate comparatives?

24. We agree.

Q16: Do you agree that financial assets and liabilities should be re-measured on the transition date?

25. We agree.

Q17: Do you agree that authorities should assess whether on transition to the 2007 SORP requirements any financial asset impairment write-downs or provisions under their existing accounting policy need to be reversed and/or whether new impairment write-downs should be provided in accordance with the 2007 SORP requirements?

26. We agree.

Q18: Do you agree that any adjustment to the previous carrying amount of financial instruments whether arising from the review of recognition and derecognition decisions made in 2006/07 or from re-measurement on transition to the 2007 SORP requirements should be recognised as an adjustment to the 2007/08 opening General Fund Balance, except for the difference between the previous carrying amount and the fair value of an Available-for-Sale financial asset, which should be recognised in an Available-for-Sale reserve?

27. [We suggest that further consideration should be given to the creation of an Available-for-Sale reserve for local authorities and how movements through this reserve should be accounted for.

Q19: Do you agree that the proposals within the 2007 ITC for premiums incurred before 1 April 2007 should not take effect unless, as expected, regulations to mitigate their impact on taxation were in force?

Q20: Do you agree that if after consultation the Joint Committee was minded to require the write down to fair value of all soft loans to be immediately expensed, the Joint Committee should not implement such

an amendment to the SORP unless, as expected, regulations to mitigate the impact on taxation were in force?

28. Questions 19 and 20 do not relate specifically to accounting issues, but to implementation of policy. The objective of the SORP is to bring accounting by local authorities into line with UK GAAP. We do not believe that progress towards this objective should be influenced or delayed by extraneous issues.

Q21: Are there any further transitional issues that should be considered?

29. No.

Q22: Do you agree that if the Joint Committee bases the 2007 SORP financial instruments accounting requirements on FRS 26 it should base the disclosure requirements on FRS 29?

30. We agree.

Q23: Do you agree with the approach outlined in paragraphs 2.49 and 2.52 above for determining the FRS 29 disclosure requirements that should be adopted by the SORP?

31. We agree.

Q24: Do you agree that the hedge accounting disclosures should not be covered in detail by the 2007 SORP?

32. We agree.

Q25: Do you have comments on specific disclosure requirements? If so, please give your comments.

33. We have no further comments.

Q26: Do you have any comments on the presentation requirements? If so, please give your comments.

34. The full implications of paragraph 92 dealing with current and long -term liabilities are not altogether clear. FRS 26 requires a loan in default to be treated as a current liability (and we note that breach of a covenant may result in a technical default). It appears therefore that paragraph 92(b) may not be in accordance with the standard. We are not sure whether this is the intention, but in any event we believe that it is essential that the SORP should follow GAAP. We suggest that the Joint Committee should readdress paragraph 92 and ensure that it is fully GAAP compliant. An example or examples may also be helpful.

Other Accounting Standards Developments

Q27: Do you agree that:

- **FRS 23 The Effects of Changes in Foreign Exchange Rates**
- **FRS 24 Financial Reporting in Hyperinflationary Economies**
- **FRS 28 Corresponding Amounts**

- **UITF Abstract 41 Scope of FRS 20**
- **UITF Abstract 42 Reassessment of Embedded Derivatives**

are the only other accounting standards developments that need to be included in amendments to the SORP?

35. We agree.

Q28: Do you agree with the amendments to the SORP proposed in respect of these standards?

36 Paragraphs 3.31 and 3.32 require the contracted rate to be used in translating monetary items denominated in a foreign currency. This was allowed under SSAP 20, but is not allowed by FRS 23 *The effects of changes in foreign exchange rates (IAS 21)*.

37. With regard to FRS 28 *Corresponding amounts*, we believe that there is an opportunity to reinforce the principles of the standard in the main body of the revised SORP. This would serve to deter local authorities from using prior year adjustments inappropriately in respect of amounts that result from reclassifications and/or in respect of immaterial items. We also suggest that additional material may be helpful to deal with disclosure required when t he comparative amounts have been changed.

Revaluation Reserve

Q29: Do you agree that the SORP should require the opening balance on the Revaluation Reserve at 1 April 2007 to be zero?

38. We disagree. We welcome the requirement for a revaluation reserve, and we understand the attractions of simplicity and certainty offered by the proposed approach. However, resetting the reserve to zero will not reflect the real position of any local authority. Subsequent annual adjustments from such an inaccurate base will merely compound the error, while the nature and scale of asset holdings means that it will be many years before the balance on the account will bear any relationship to the true position. Furthermore, a zero balance will create difficulty where an impairment is identified, as the resultant charge will, for lack of alternative, go direct to Income and Expenditure.

Q30: If not, what practical method should be used to establish the opening balance on the Revaluation Reserve?

39. We suggest that local authorities should be given a range of options for establishing the revaluation reserve, so that the most appropriate approach can be adopted for the specific circumstances, including consideration of cost/benefit factors. The SORP could set out illustrative examples and emphasise the need for full disclosure to provide contextual explanations of numbers.

40. We agree with the point made in the Invitation to Comment, that to be consistent with companies in applying UK GAAP local authorities should include the historical cost of an asset according to the earliest available record. We accept that few local authorities have comprehensive historical cost records for their assets, and that the large number of assets will make calculations time-consuming. However, the impact of the SORP is that they

will have to start identifying data for individual assets anyway, and it is this effect rather than the restatement that will generate most work. If the Joint Committee were to mandate a single approach, then we believe it should be this one, representing the best approximation of historical cost and the closest alignment with UK GAAP. However. we set out in an Appendix an alternative approach that the Joint Committee might consider worthy of attention. As set out above, we suggest that the Joint Committee should not mandate a single approach.

Legislative Developments – Local Area Agreement Grant

Q31: Do you agree that where the Accountable Body in substance controls the award of LAA grant to others all grant receivable from Central Government and awarded to others should be recognised as income and expenditure of the Accountable Body?

Q32: Do you agree that where the Accountable Body does not in substance control the award of grant to others, the accountable body should not recognise all the LAA grant channelled through the authority as income but only such grant as is awarded to it?

41. We agree with questions 31 and 32. However, there are two issues that the Joint Committee might wish to consider before finalising the SORP. We are concerned that in effect two different treatments are allowed for essentially the same transaction, and we question whether this makes sense in the context of Whole Government Accounting. Similarly, it appears that there will be occasions on which the grant is recognised by both the lead local authority and the Council that is ultimate recipient of the grant.

Q33: Do you agree that where amounts of LAA Grant has or may become repayable to Central Government:

- **where a formal requirement to repay a known amount exists a creditor should be recognised?**
- **where it is probable but not certain that a repayment will be required or if the amount of the repayment is not known with certainty, provision should be made?**
- **where it is virtually certain that the Accountable Body will be able to recover some or all of any monies it is required to repay it should recognise a debtor for the recovery?**
- **where recovery is probable a contingent asset should be disclosed?**

42. We agree. It may be helpful to include additional material dealing with other situations in which there are potential contingent liabilities.

Q34: Do you agree that allocations of LAA Grant receivable from the Accountable Body that are recognisable as income should be accounted for on an accruals basis in accordance with paragraphs 3.32 to 3.34 of the SORP?

43. We agree.

Q35: Do you agree that LAA Grant is a specific grant but is likely to relate to more than one local authority service?

44. We agree.

Q36: Do you agree that LAA Grant transactions recognised in revenue should be apportioned between the services that are funded by the grant?

45. We agree.

Q37: Do you agree that the following disclosures on Local Area Agreements should be included as a note to the core financial statements?

"Sufficient information on Local Area Agreements to allow for the understanding of the authority's financial affairs. As a minimum this includes the purpose of the LAA, the identities of partner bodies, the name of the Accountable Body, the total amount of LAA Grant received under the LAA and the amount of LAA Grant received by the authority."

46. We agree in principle with this disclosure. However, we suggest that in practice listing the identities of all partner bodies would be onerous for preparers and unhelpful for users. We suggest that materiality considerations should be brought to bear.

Charitable Trusts Consolidated into the Group Accounts of a Local Authority

Q38: Do you agree that the disclosure of charitable trust assets and liabilities consolidated into group accounts needs to be improved?

Q39: Do you agree that new paragraph 5.14a above should be added to the Group Accounts chapter of the SORP? If you do not agree, what do you propose should be done to improve the disclosure of charitable trust assets and liabilities consolidated into group accounts?

47. We agree with questions 38 and 39.

Q40: Do you agree that new note (h) above should be added to the information to be disclosed in the notes to the Group Accounts?

48. We agree. However, we suggest that the Joint Committee should consult on the impact of charitable assets and liabilities on single entity accounts, particularly in relation to schools and leisure trusts

Northern Ireland Local Government Officers Superannuation Scheme

Q41: Do you agree that the classification of the Northern Ireland Local Government Officers Superannuation Scheme should be changed to a defined benefit scheme to be accounted for in accordance with the accounting policies set out in paragraphs 3.71 – 3.78 and appendix F of the SORP? Please give your reasons why you think this change should or should not be made.

49. We agree that if the surplus/deficit can analysed between employers then this change in accounting is appropriate.

Q42: Do you agree that if the classification is changed the amendment should be implemented in 2007-08? If you consider that the change should be deferred please give your reasons.

50. We agree.

Q43: Do you agree that if the classification is changed it should this be treated as a material prior period adjustment?

51. We disagree. If the change results from the use of information that was previously unavailable, then it should be a current year item.

Applicability of the SORP

Q44: Do you agree with the proposed above amendments to the paragraphs that deal with the 'Applicability of the SORP'?

52. We agree.

OTHER MATTERS

53. In addition to the matters specifically consulted on we consider that the Joint Committee should consider the following:

- Accounting for Large Scale Voluntary Transfers (LSVT) and related VAT Shelters.

- Presentation requirements for reconciliation of I&E to General Fund to include more information in the primary statement given the materiality of reconciling items noted by many authorities in restating 2005-06 accounts. This may help address concerns at the size of I&E deficits being reported.

- How balances held on revaluation reserve are to be accounted for when revaluation gains are effectively realised on disposal of an asset. Under UK GAAP these are released to I&E as a reserve movement but the I&E is only an in year statement for local authorities.

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APPENDIX: Alternative approach to establishing the revaluation reserve.

One approach to establishing the revaluation reserve would be to go back to the start of the current capital accounting regime on 1 April 1994. At that point, the fixed asset restatement account was established, generally as the difference between the previous carrying value of all assets and the newly determined current value. Details of that figure should be readily available. In practice, there may be Authorities which established the Fixed Asset Replacement Account (FARA) as the full amount of the new asset carrying value, as they cleared the previous value through the capital finance reserve.

Sine that date, local authority practice has not complied with GAAP for several reasons, of which the most significant is that on disposal it has not been commonplace to write out only that element of the attributable FARA balance. The other significant issue is the common practice of debiting to FARA any element of capital expenditure that does not lead to a commensurate increase in carrying value.

We suggest that as one of the alterative approaches, the SORP should allow local authorities to calculate a materially accurate figure based on the 1994 general revaluation, adjusted by means of a broad estimate for subsequent disposals. In practice, the impact on different classes of asset may be very different, and in making that estimate councils will wish to consider each separately. Secondly, Authorities should consider the extent to which they have employed the FARA to absorb what might more properly have been treated as impairment. We accept that the amount of work involved may be quite significant, and may well involve revisiting all accounts since 1994/5, but this is a one-off exercise, and the benefits of improved accuracy will be felt for a number of years.