

## ICAEW REP 06/06

### CODE OF PRACTICE ON LOCAL AUTHORITY ACCOUNTING IN THE UK 2006 - A STATEMENT OF RECOMMENDED PRACTICE

*Memorandum of comment submitted in January 2006 by the Institute of Chartered Accountants in England and Wales, in response to the exposure draft of amendments to the Statement of Recommended Practice 'Code of Practice on Local Authority Accounting in the UK 2006', published by the Chartered Institute of Public Finance and Accountancy in November 2005.*

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## **INTRODUCTION**

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the exposure draft of proposed amendments to the Statement of Recommended Practice (SORP) Code of Practice on Local Authority Accounting in the United Kingdom 2006, published by CIPFA/LASAAC in November 2005.

## **WHO WE ARE**

2. The Institute of Chartered Accountants in England and Wales (the 'Institute') is the largest accountancy body in Europe, with more than 127,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

## **MAJOR ISSUES**

4. We congratulate CIPFA/LASAAC on making important progress towards convergence with GAAP. However, there are areas that still need to be addressed, including matters raised in our response to the 2005 Code of Practice:
  - Accounting for financial instruments;
  - Treatment of unamortised premiums;
  - Disclosure of related party transactions.

As in our previous response, these matter are dealt with in an appendix. We also comment below in paragraph 37 on the Joint Committee's lack of progress on accounting for financial instruments.

## **SPECIFIC QUESTIONS**

### **THE CAPITAL FINANCING CHARGE**

*Q1 Do you agree with the proposed amendments to the SORP that implement the removal of the capital financing charge? If not please give details of your concerns or suggestion for improvement.*

5. Yes. Any historical reasons for including a capital financing charge are no longer applicable.

## **PROPOSED CHANGES TO THE SINGLE ENTITY STATEMENT OF ACCOUNTS**

### **Background issues**

*Q2 Do you agree that the current format of the statement of accounts is difficult to understand without a detailed knowledge of local government accounting?*

6. Yes. It is important to make the primary statements understandable. The current format militates against this.

*Q3 Do you agree that the entries in the 'appropriations' section of the Consolidated Revenue Account are not income or expenditure according to UK GAAP but transfers to or from the General Fund that in accordance with UK GAAP would be disclosed as movements on reserves?*

7. Yes.

### **Proposed Income and Expenditure Account**

*Q4 Do you agree that the local authority statement of performance should be a traditional Income and Expenditure Account?*

8. Yes.

*Q5 Do you broadly agree with the suggested format of the proposed Income and Expenditure Account, eg that it should comprise three sections:*

- ***Section 1:** Net cost of services in the same format as the present CRA (but with the capital charge replaced by a charge for depreciation).*
- ***Section 2:** Net operating expenditure in an essentially similar format as at present but with the line for Net Income and Expenditure on the Asset Management Account removed and the items that are currently contained in the line (after the removal of notional interest) dealt with in accordance with UK GAAP eg Interest Payable shown as a separate line.*
- ***Section 3:** an Income from local taxation and general government grants section that is essentially the same as at present.*
- *Removal of the appropriation section of the present CRA and the amounts included within it dealt with in accordance with UK GAAP as legislation related reserve movements that would be shown in a separate statement following the Income and Expenditure Account reconciling the Income and Expenditure Account surplus or deficit for the year to the movement on the General Fund.*

9. Yes.

### **Proposed Reconciliation of the Movement on the General Fund**

*Q6 The surplus or deficit shown on the present Consolidated Revenue Account is the movement for the year on the General Fund Balance. Do you agree that a statement*

*reconciling the surplus or deficit on the proposed Income and Expenditure Account to the movement on the General Fund Balance would be helpful to users?*

10. Yes. It will be helpful to users to gain a better understanding of the nature of the General Fund balances carried forward from one year to the next.

*Q7 Do you agree that the statement reconciling the surplus or deficit on the Income and Expenditure Account to the movement on the General Fund Balance should be shown on the face of the accounts rather than as a note to the statement of accounts?*

11. Yes, we broadly agree. Showing the movement in the level of reserves without forcing the reader to consult the notes to the accounts is a useful presentation. However, we note that the example given is relatively simple. The principle is that highly summarised information should be supplemented first by an analysis and then by notes, and notes will generally be necessary in order to make the information meaningful. This is an area that needs to be kept under review.

*Q8 Assuming it were decided that the statement reconciling the Income and Expenditure Account surplus or deficit to the movement on the General Fund Balance should be shown on the face of the accounts, do you agree that it should immediately follow the Income and Expenditure Account such that the two statements together give comparable information to that presently given by the Consolidated Revenue Account?*

12. Yes, we broadly agree. This will need to be revisited in the light of developing practice.

*Q9 Do you agree that it would be helpful to users of accounts to explain in a note to the accounts the significance for local taxation and the funding of services of the statement reconciling the Income and Expenditure Account surplus or deficit to the movement on the General Fund Balance for the year?*

13. Yes. However, it needs to be clear that this is not calling for an explanation of funding policy. The explanation should be sufficient to allow the reader to understand the nature and source of the reconciling items

*Q10 What in your view should the proposed statement reconciling the surplus or deficit on the Income and Expenditure Account to the movement on the General Fund Balance be called? So far, two options have been put forward:*

- *Option A* – Reconciliation of Movement on the General Fund; *and*
- *Option B* – Reconciliation of the Surplus or Deficit on the General Fund.

*Please indicate whether you prefer Option A or Option B or alternatively suggest another name for the statement.*

14. We prefer the more descriptive title ‘Reconciliation of the [Deficit] on the Income and Expenditure Account to the [Surplus] on the General Fund’, as set out in the example.

## **Proposed replacement of the Statement of Total Movements in Reserves with a Statement of Total Recognised Gains and Losses**

*Q11 Do you agree that the FRS 3 Reporting Financial Performance requirement that “A primary statement should be presented, with the same prominence as the other primary statements, showing the total of recognised gains and losses and its components”, which is currently met by the long and complex Statement of Total Movement in Reserves could be met more simply by replacing it with a Statement of Total Recognised Gains and Losses?*

15. Yes.

*Q12 Currently the Statement of Total Movements in Reserves also partly fulfils the function of a Statement of Movement on Reserves but is difficult to understand in the current complex format. Do you agree that this information could be presented more simply in a note to the accounts disclosing the movements on reserves?*

16. Yes. Clear notes will be required in order to distinguish the different purposes of the different reserves.

## **Proposed format of the Housing Revenue Account statement**

*Q13 Do you agree that notwithstanding its ‘memorandum’ nature the HRA statement should continue to be given the same prominence as a ‘core’ primary statement?*

17. Yes. Although the HRA is a supplementary statement, we would be happy for it to be given the same prominence as a core statement if the order of presentation suggested at paragraph 4.28 were to be adopted. This information can be important in demonstrating, for example, that there are no cross-subsidies. It is important to bear in mind that the HRA is not an analysis of the numbers in the CRA, which will include housing items that do not relate to the housing stock. We therefore concur with the view of the Joint Committee set out in paragraph 4.28, that a good practice would be to present in the order core statements, related notes, supplementary statements, related notes.

*Q14 Do you agree that the replacement of the CRA with an Income and Expenditure Account would make it necessary to revise the HRA statement since it follows the CRA format by having an ‘appropriations’ section (in England and Wales)?*

18. Yes.

*Q15 Do you agree that the main options for revising the HRA statement would be:*

- (a) *an HRA Income and Expenditure Account that shows in more detail the HRA services income and expenditure included in the whole authority Income and Expenditure Account supported by a statement reconciling the HRA Income and Expenditure Account surplus or deficit to the statutory HRA surplus or deficit?*

- b) *a Statutory Housing Revenue Account that discloses the statutory surplus or deficit on the HRA followed by a statement reconciling this to the surplus or deficit on HRA activities as reported in the Income and Expenditure Account?*

*If you do not agree, please suggest any other option for amending the format of the HRA that you prefer?*

19. Yes.

*Q16 Do you agree with the Joint Committee's proposal that the present HRA statement should be replaced by a HRA Income and Expenditure Account supported by a statement reconciling the HRA Income and Expenditure Account surplus or deficit to the statutory HRA surplus or deficit (ie option (a) above)?*

20. On balance we agree that (a) is preferable, as the supplementary statement presented for statutory reasons will be easier to understand if it is in a similar format to that of the primary statement.

### **Order of the Statement of Accounts statements**

*Q17 Do you agree that authorities that are required to keep a statutory Housing Revenue Account and or Collection Fund, or other statutorily required statement that is not a 'core' statement, should prepare accounts that group the authority's core statements together, followed by the notes to the core statements, followed by the 'supplementary statements' eg HRA and Collection Fund and with the notes to the supplementary statements following each supplementary statement?*

21. Yes. If these statements are required they should be separated and distinguished from the core statements as suggested. We suggest that it might be beneficial to set out the SORP in the same order as proposed for the financial statements.

*Q18 Do you agree that for authorities that prepare only core statements the statements should be grouped together followed by the notes to the accounts grouped together?*

22. Yes.

### **PROPOSED CHANGES TO THE GROUP ACCOUNTS**

*Q19 Do you agree that the format of the Group Accounts should be amended to make it as similar as possible to the proposed new format of the single entity statement of accounts?*

23. Yes. It is important to be consistent.

*Q20 Do you agree that the performance related Group Accounts statements should comprise:*

- *a Group Income and Expenditure Account in similar format to the single entity Income and Expenditure Account*

- *a statement reconciling the Group Income and Expenditure Account surplus or deficit for the year to the single entity Income and Expenditure surplus or deficit for the year*
- *a Group Statement of Total Recognised Gains and Losses that would replace the present Group Statement of Total Movements in Reserves?*

24. Yes.

*Q21 Do you agree that there should be a note to the accounts disclosing the group's movement on reserves?*

Yes.

**PROPOSED REVALUATION RESERVE AND CONSEQUENT CHANGES TO THE FIXED ASSET RESTATEMENT ACCOUNT AND CAPITAL FINANCING ACCOUNT**

*Q22 Do you agree that there is no legislative bar to local authorities maintaining a Revaluation Reserve? If you do not agree, please give reasons.*

25. We are not aware of any legislative bar.

*Q23 Do you agree that the current SORP's treatment of fixed asset revaluation gains and losses cannot be justified on the grounds of being more appropriate for local authorities than the UK GAAP treatment?*

26. Yes.

*Q24 Do you agree that the SORP requirement to maintain a Fixed Asset Restatement Account and Capital Financing Account should be replaced by a requirement to maintain a Revaluation Reserve and a Reconstituted Capital Financing Account?*

27. Yes.

*Q25 Do you agree that few local authorities would have readily available historical costs for all or substantially all of their revalued fixed assets?*

28. Yes.

*Q26 Do you agree that for fixed assets where a reliable historical cost cannot be established at reasonable cost, the most appropriate 'proxy' figure for historical cost available should be used?*

29. Yes.

*Q27 Do you agree with the proposed approach for establishing appropriate proxy figures for historical cost?*

30. Yes. The figures need to be supportable, but, particularly in the light of materiality considerations, a pragmatic approach can be justified. We would encourage the

development of further guidance on the problems of practical application. However, we agree that this would not be appropriate in the SORP, which in our view is pitched at the right level. We note that a better understanding of the asset base is likely to lead to better asset management plans.

*Q28 Do you agree with the proposed approach to establishing the opening balances on the Revaluation Reserve and Reconstituted Capital Financing Account?*

31. Yes.

*Q29 Do you agree that the Capital Financing Account should be renamed after it had been 'reconstituted' as a consequence of establishing a Revaluation Reserve?*

32. Yes.

*Q30 Do you favour any of the following suggestions for a new name for the Reconstituted Capital Financing Account? These are:*

- *Residual Reserve*
- *Residual Equity Reserve*
- *Fixed Capital Reserve*
- *Unusable Reserve.*

*If you favour one of these suggestions, please say which. If you were able to suggest another name you prefer, your suggestion would be welcome.*

33. We suggest 'Technical Accounting Reserve'. We believe that this will serve to alert the reader to the fact that the reserve is unusual in nature.

#### **PRIOR YEAR ADJUSTMENTS**

*Q31 Do you agree that the SORP provisions on prior year adjustments apply to:*

- *the amendments proposed in the ITC regarding removal of notional interest;*
- *removal of amounts that are not gains or losses from the statements of performance; and*
- *changes to reserves?*

34. Yes. We are not convinced that all these items are changes in accounting policies, but we believe they should be treated as prior year adjustments in order to achieve comparability.

*Q32 Do you agree that there are no compelling reasons for not implementing the SORP requirements on prior year adjustments?*

35. We agree.

*Q33 If you consider that there are compelling reasons not to implement the SORP's requirements on prior year adjustments, please state the reasons and any suggestions you may have on the way the change should be implemented.*

36. Not applicable.

## **NEW FINANCIAL INSTRUMENTS STANDARDS**

*Q34 Do you agree that except for authorities that have issued listed securities, local authorities are not within the scope of FRS 25 and FRS 26 except for the 'presentation' requirements of FRS 25?*

*Q35 Do you agree that the SORP should not be amended to require authorities that have issued listed securities to adopt the disclosure and measurement requirements of FRS 25 and FRS 26 at this time?*

*Q36 Do you agree that the SORP should be amended to require local authorities to adopt the 'presentation' requirements of FRS 25?*

*Q37 Do you agree that the other requirements of FRS 25 and FRS 26 (ie 'disclosure' and 'measurement') should not be adopted voluntarily at this time?*

37. We are disappointed with the Joint Committee's approach to the question of financial instruments. In general, Local Authorities do not comply either with the pre-existing standards (FRS 4 and FRS 13) or the new standards (FRS 25 and FRS 26). We are concerned that laxity in this area could have serious consequences for financial decision making. While we note that the Joint Committee has issued a discussion paper on the adoption of FRS 25, FRS 26 and FRED 33, this should not be used as an excuse to defer implementing the current standards. The sector should either adopt current standards or move to FRS25/26 straight away. Some further comments are set out in the appendix.

## **OTHER ACCOUNTING STANDARDS DEVELOPMENTS**

*Q38 Do you agree that:*

- *FRS 22 – Earnings Per Share*
- *RS 23 – The Effects of Changes in Foreign Exchange Rates*
- *FRS 24 – Financial Reporting in Hyperinflationary Economies*
- *FRS 27 – Life Assurance*
- *UITF Abstract 39 – Members' Shares in Co-operative Entities and Similar Instruments*
- *UITF Abstract 40 – Revenue Recognition and Service Contracts*

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

38. We note that FRS 28 *Corresponding amounts* has also been issued. However, we assume that this missed the cut-off date for inclusion in the SORP. As it is anyway primarily a codifying measure, we are content to have it dealt with in the 2007 SORP

*Q39 Do you agree with the amendments to the SORP proposed in respect of these standards?*

39. We have no comments on this question.

## **LEGISLATIVE DEVELOPMENTS**

### **Landfill Allowances Trading Scheme (England) and Landfill Allowances Scheme (Wales)**

*Q40 Do you agree that the Landfill Allowance Trading Scheme (England) is a 'cap and trade' scheme of the type that the proposed UITF Abstract Emission Rights covers?*

40. Yes.

*Q41 Do you agree that WDAs in England should account for their LATS activities in accordance with proposed UITF Abstract Emission Rights?*

41. Yes. This is probably the best model available.

*Q42 Do you agree that the SORP should require WDAs in England to adopt a 'lower of cost and net realisable value' accounting policy for remeasuring the value of allowances?*

42. Yes. This is a pragmatic solution that will help to minimise distortion. However, it leads to different treatments of the asset and the liability. This should be kept under review.

*Q43 Do you agree that the Landfill Allowance Scheme (Wales) is **not** a 'cap and trade' scheme of the type that the proposed UITF Abstract Emission Rights covers?*

43. Yes.

*Q44 Do you agree that the possible liability for penalty payments to the Welsh Assembly Government arising from an authority using more landfill than its 'target' should be accounted for in accordance with paragraphs 3.70 to 3.71 of the SORP on 'Provisions'?*

44. Yes

*Q45 Do you agree that where a possible liability for penalty payment to the Welsh Assembly Government exists, but the authority has concluded that it does not need to make a provision, it should disclose this as a separate category of contingent liabilities in the notes to the statement of accounts?*

45. We agree in principle, subject to normal materiality considerations, but we question whether this is an appropriate issue for a SORP.

## **OTHER DEVELOPMENTS**

### **Emoluments/remuneration**

*Q46 Do you agree that the definition of emoluments contained in the SORP should be changed to bring it in to line with other sectors?*

46. Yes.

*Q47 Do you agree with the proposed amendment to the SORP highlighting the need for surpluses or deficits arising from internal trading to be allocated to the recipient services?*

47. Yes.

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## **APPENDIX: ADDITIONAL ISSUES TO BE DEALT WITH IN THE SORP**

### **Financial instruments**

1. Local authorities are using an increasing range of financial instruments. Authorities used to borrow principally through the Public Works Loan Board (PWLB) but are now increasingly borrowing from private sector sources using sophisticated financial instruments such as Lender Option Borrower Options (LOBOs), sometimes with stepped increases in interest rates. The introduction of the Prudential Code with effect from 1 April 2004 is likely to result in more authorities making use of more sophisticated financial instruments.
2. We therefore suggest that the SORP should include the principal requirements of FRS 13 *Derivatives and other financial instruments*. These requirements are currently included within the Government's Resource Accounting Manual (RAM) and will therefore be required to provide comparability as local authorities move towards WGA.
3. As noted above some authorities are now using stepped interest LOBOs. We suggest that the SORP should provide clarification, following FRS 4 principles, as to how interest should be spread where such instruments are used.

### **Premiums**

4. The SORP includes an exemption from FRS 4 requirements on recognising premiums in the year: 'Where ... the repurchase of borrowing was coupled with a refinancing or restructuring of borrowing with substantially the same overall economic effect when viewed as a whole, gains or losses should be recognised over the life of the replacement borrowing.' It would be helpful if the SORP provided clarification on the test relating to 'same overall economic effect' and the position where the restructuring of debts includes financial instruments such as LOBOs.
5. Many authorities now carry forward significant amounts as unamortised premiums. The SORP does not specify how these should be disclosed within the accounts, and in practice authorities have disclosed them under different headings:
  - Prepayments; or
  - Long-term debtors.

In our view, these should be disclosed under long-term debtors with a supporting note showing the period over which they are to be written off, in order to provide greater clarity on the future impact of unamortised premiums.

6. The SORP does not cover how to deal with the unamortised balance of any premium if the replacement borrowing is repaid early. Practice at many authorities has been to continue to spread unamortised premiums over the life of replacement borrowing even if this has been repaid. In some circumstances this has resulted in debt-free authorities carrying forward unamortised premiums arising on the early settlement of

debt. We suggest that the SORP should be amplified to provide guidance on how unamortised premiums should be treated in these circumstances.

### **Related parties**

7. We have identified inconsistencies in disclosures relating to related parties and we therefore suggest that it would be appropriate to provide clarification on what is required, either in the SORP or in Guidance Notes.

Areas where clarification would be helpful include:

- Bodies under common control, such as NHS bodies;
- Situations where a local authority member (or officer) sits on a local body on behalf of the Council but does not derive any personal benefit from this position; and
- Situations where the authority provides financial assistance to organisations and individuals (either from its own funds or through grant funding received from other government bodies).

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