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Item 6c. LASAAC 27/02/19

13th February 2019

Dear Gareth

LASAAC consultation on mandatory guidance for Scottish local authorities from 2018/19 - IFRS 9 financial instruments - Earmarking of gains not available to fund services

Arlingclose advises six Scottish local authorities on treasury management and capital finance issues and we therefore welcome the opportunity to respond to this consultation.

Broad approach

Arlingclose agrees that it is rarely prudent to cut Council tax or provide additional services based on unrealised gains that could easily reverse in later years, and we are therefore broadly supportive of the proposal to defer many unrealised gains until the asset is sold and the gain is received in cash.

But we equally believe that local authorities should not have to raise Council tax or cut services based on unrealised losses that are equally likely to reverse. An equal treatment of gains and losses would be aligned with the previous requirements of IAS 39 for available-for-sale assets, the impact of the broader capital expenditure definition in the rest of the UK and the new pooled fund override in England.

Should LASAACC keep the asymmetric position, we feel it is important that the guidance clarifies that losses that reverse gains on the same asset in previous years should be used reduce the earmarked portion, in a similar manner to the operation of the revaluation reserve for property, plant and equipment. Equally, gains that reverse losses incurred on the same asset in previous years should not be earmarked. This approach is inferred but not explicit in the consultation draft.

Detailed proposals

Looking at the detail, we think that paragraph 6(a) could be worded better, since it is unclear whether it refers to *values* that can be determined without negotiation/marketing or to *transactions* that could occur without negotiation/marketing; the latter is clearly a more stringent test. It is also unclear whether giving a sell order to a broker or posting it on an exchange counts as marketing.

We also think that further guidance on the meaning of "volatile" in paragraph 8 would be useful, maybe by reference to examples. Almost anything that can go up in price can go down again and could therefore be described as volatile.

Paragraph 4 briefly mentions unrealised gains on modified financial liabilities (e.g. after a debt restructuring) but the draft gives no guidance on when such gains might be considered to be realised. This could be over the life of the loan through the amortisation process or only upon derecognition of the liability upon maturity of the replacement loan.

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One category of financial instruments held at FVPL not mentioned by the draft is derivatives. Even though local authorities in Scotland may not use standalone derivatives, they do have embedded derivatives that could be accounted for separately and hence create fair value gains and losses in revenue. The same is true of forward contracts on loans and investments. We suggest that the guidance clarifies whether it applies to these accounting entries and when such gains and losses are to be treated as realised.

Finally, we feel that the presentation in an earmarked portion of the General Fund could be confusing to users of the accounts, since the entire General Fund is presented within usable reserves (defined as those that can be applied to fund expenditure or reduce local taxation) whereas the purpose of the proposed earmarking is to identify sums that are not available to fund the delivery of services. We recommend use of an unusable reserve, such as the Financial Instruments Adjustment Account instead.

If I can be of any further assistance, please do not hesitate to contact me.

Yours sincerely

David Green
Strategic Director