

## **7 FINANCIAL INSTRUMENTS**

### **7.1 Introduction, Scope, Recognition and Initial Measurement, Hedge Accounting, Derivatives and Embedded Derivatives and Definitions**

#### **7.1.1 Introduction**

7.1.1.1 Authorities shall account for financial instruments in accordance with *IAS 39 Financial Instruments: Recognition and Measurement*, *IAS 32 Financial Instruments: Presentation* and *FRS 7 Financial Instruments: Disclosures*, except where interpretations or adaptations to fit the public sector are detailed in the Code.

#### *Interpretation and adaptation for the Public Sector Context*

7.1.1.2 The following interpretations or adaptations have been adopted by the Code:

- (a) 'Regular way' trades of financial assets

*IAS 39* permits either 'trade date' or 'settlement date' accounting to be used for 'regular way' trades of financial assets. This discretion is not permitted by the Code. The trade date rather than the settlement date shall be used to recognise the regular way purchase or sale of a financial asset (see paragraphs 7.1.3.4–7.1.3.5 for the detailed requirements).

- (b) Designation of the category of a financial instrument

*Under IAS 39*, subject to restrictions, it is in certain circumstances permitted to 'designate' a financial instrument to a different category to the one to which it would inherently belong under *IAS 39*. The Code does not permit such designations (see paragraph 7.1.5.3).

- (c) Soft loans advanced by an authority – 'prevailing interest rate'

The Code provides guidance on estimating the 'prevailing interest rate' that a borrower to whom it has advanced a 'soft loan' could have borrowed in an arm' length transaction (see paragraphs 7.1.4.5 for the detailed requirements).

- (d) Soft loans received by an authority 'prevailing interest rate'

For the purposes of calculating the fair value on initial recognition of a soft received by a local authority, the Code provides an interpretation of how the 'prevailing interest rate' at which it could have borrowed in an arm' length transaction shall be determined (see paragraph 7.1.4.10).

- (e) Lender Option Borrower Option Loans (LOBOs)

The Code requires:

- options embedded in a LOBO shall not be separately accounted for unless after considering the contractual terms of the instrument the authority concludes that *IAS 39* would require the embedded options to be accounted for separately (see paragraph 7.1.6.9);
- the contractual life and contractual cash flows shall be used as the expected life of a LOBO when calculating the effective interest rate on initial recognition, unless on considering the contractual terms of the instrument the authority concludes it is able to estimate reliably the expected cash flows or expected life (see paragraph 7.2.2.8).

(f) Accounting for immaterial transaction costs on initial recognition

The Code gives an option to write off immediately to Surplus or deficit on provision of services transaction costs that the Code would usually require to be applied to adjust a financial instrument's initial carrying amount, where they are immaterial.

(g) Exchanges of debt instruments

The Code (and *IAS 39*) requires under defined circumstances, the gain or loss on an exchange of debt instruments between an existing borrower and lender to be used to adjust the carrying amount, rather than be recognised immediately in Surplus or Deficit on provision of services. The Code has interpreted this as requiring the exchange of loan instruments and associated settlement of any fees or costs incurred to take place on the same day and as not requiring net settlement as long as any payments between the lender and borrower are made on the same day. Overwhelmingly the main lender to local authorities is the Public Works Loan Board (PWLB), which is not permitted to settle these amounts net but must receive payment of the agreed settlement amount of the original loan.

*Statutory Accounting Requirements*

7.1.1.3 There are statutory accounting requirements regarding:

- (a) 'Soft loans' (ie loans at nil or below prevailing interest rates) advanced by a local authority, which is covered in paragraphs 7.1.4.6–7.1.4.8).
- (b) Premiums paid or discounts received on the early repayment of loan debt, which is covered in Code paragraphs 7.2.3.5–7.2.3.6.

### *Disclosure Requirements*

- 7.1.1.4 Financial instrument disclosure requirements can be found in paragraphs 7.4.2.1–7.4.3.9.

### *Statutory Disclosure Requirements*

- 7.1.1.5 There are no statutory disclosures required in relation to financial instruments.

### *Changes since SORP 2009*

- 7.1.1.6 There have been no changes in accounting requirements since SORP 2009.

### *What the section and Chapter covers*

- 7.1.1.7 This first section of Chapter 7 on financial instruments covers:
- (a) scope of the financial instruments standards and this Code Chapter
  - (b) initial recognition and measurement of financial instruments
  - (c) classification of financial instruments
  - (d) hedge accounting
  - (e) derivatives and embedded derivatives
  - (f) definitions of the key terms used in the Chapter.

Chapter 7 contains three further sections covering:

**Section 2** – Accounting for financial liabilities after initial recognition

**Section 3** – Accounting for financial assets after initial recognition

**Section 4** – Presentation and disclosures.

## **7.1.2 Types of financial instruments covered by the Chapter**

- 7.1.2.1 A 'financial instrument' is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. The term 'financial instrument' covers both financial assets and financial liabilities and includes both the most straightforward financial assets and liabilities such as trade receivables and trade payables and the most complex ones such as derivatives and embedded derivatives. Typical financial instruments are:

#### Liabilities

- trade payables and other payables
- borrowings
- financial guarantees

#### Assets

- bank deposits
- trade receivables
- loans receivable
- other receivables and advances
- investments

#### Derivatives

- swaps
- forwards
- options

#### Embedded derivatives

- debt instruments with embedded swaps
- debt instruments with embedded options.

#### *Scope exclusions*

7.1.2.2 Some types of financial instruments covered by *IAS 39* are not covered in detail by the Code because they are not relevant to entities that do not issue equity instruments. The applicable IFRS accounting standards shall be followed if circumstances were such that the provisions concerning equity instruments became relevant eg in Group Accounts (see Code Chapter 9 *Group Accounts*). This Code chapter does not cover the following types of financial instruments since they are within the scope of other accounting standards rather than *IAS 39* and are dealt with elsewhere in the Code. These are:

- (a) Interests in subsidiaries, associates and joint ventures, which are covered by Code Chapter 9 *Group Accounts*.
- (b) Rights and obligations under leases, which are covered by Code section 4.2, except for lessors' lease receivables with respect to the derecognition and impairment provisions of this Chapter; lessees' lease payables with respect to the derecognition provisions; and derivatives that are embedded in leases.
- (c) Employers' rights and obligations under employee benefit plans, which are covered by Code Chapter 6.
- (d) 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 this Chapter. Loan commitments not within the scope of this Chapter (*and IAS 39*) shall (where onerous) be accounted for in accordance with the provisions of section 8.2 of the Code and *IAS 37* on onerous contracts (paragraphs 66 to 69 of *IAS 37* refer).
- (e) Contracts to buy or sell non-financial items (eg commodity futures contracts) are outside the scope of this Chapter 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.
- (f) Financial instrument contracts and obligations under share-based transactions to which Code Appendix A paragraph A.1.6 applies.
- (g) 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 7.2.4.1–7.2.4.4 of this Chapter of the Code.

- (h) 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.
- (i) Special considerations apply in respect of receivable and payables arising from non-exchange transactions such as council tax (see Code sections 5.3 and 8.1).

### 7.1.3 Initial recognition of a financial instrument

7.1.3.1 A financial asset or liability shall be recognised in the Balance Sheet when, and only when, an authority becomes a party to the contractual provisions of the instrument. In the case of a financial asset or a derivative, this is when the purchaser becomes committed to the purchase (ie the contract date) and is usually referred to as the 'trade date'. The sale of a financial asset is also recognised on the trade date. Trade receivables are an exception. The receivable is not recognised when an authority becomes committed to supply the good or service but when the ordered goods or services have been delivered or rendered (see Code section 5.3 for further details). Similarly a trade payable is recognised when the ordered goods or services have been received (see Code section 8.1 for further details).

7.1.3.2 In the case of a financial liability an authority does not become a party to the contractual provisions of a financial liability unless one of the parties has performed. For example a loan debt contract is recognised by the borrower when the cash lent is received rather than when the authority became committed to the loan agreement; and a trade payable is recognised when the ordered goods or services have been received.

7.1.3.3 For the vast majority of financial instruments the recognition point will be obvious. However, in the case of complex instruments where the amounts receivable or payable are conditional it may require careful analysis to determine when the holder became a party to the contractual provisions, and in such cases the recognition point shall be determined in accordance with *IAS 39*. Paragraph 14 of *IAS 39* and the application guidance contained in paragraphs AG34–AG35 of *IAS 39* are of key relevance.

#### *'Regular way' trades of financial assets*

7.1.3.4 *IAS 39* permits one exception to the requirement to recognise or derecognise a financial asset on the trade date. This concerns *'regular way'* trades of financial assets. A regular way trade is one where the contract for the purchase or sale of a financial asset has terms that require delivery of the asset and payment of the consideration within an established timeframe for the marketplace concerned. Because of the short duration between the trade date and settlement date, such *'regular way contracts'* are not recognised as derivative contracts under the Code between the trade date and settlement date but are accounted for in a manner consistent with the way the asset will subsequently be measured ie depending on classification.

The main example of this would be the purchase or sale of securities on a stock exchange.

- 7.1.3.5 *IAS 39* permits either trade date or settlement date accounting to be used. However, this discretion is not permitted by the Code. The trade date rather than the settlement date shall be used to recognise the regular way purchase or sale of a financial asset. Under trade date accounting, the asset to be received and the related obligation to pay for it shall be recognised on the date that the contract is entered into. Similarly, the asset that is sold is derecognised on the date the contract is entered into, and the gain or loss on disposal and the receivable from the buyer for the proceeds are recognised on this date.

#### **7.1.4 Initial measurement of financial instruments**

- 7.1.4.1 Financial assets and liabilities shall be measured initially at fair value less, in the case of a financial asset or liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial instrument. Transaction costs include fees and commissions paid to agents, advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include internal administrative costs.

- 7.1.4.2 Fair value is the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's-length transaction. Usually the best evidence of the fair value is the transaction price (ie the consideration) and unless the transaction was not at arm's-length this should be the value used. However, if the transaction is not based on market terms, a valuation technique shall be used to determine the appropriate fair value for initial recognition of the instrument. Typical examples of transactions that might not be made on market terms are:

- interest free or low interest loans advanced by an authority (commonly to local voluntary sector organisations) which are often referred to as 'soft loans'
- soft loans made by a local authority to subsidiary bodies consolidated into their group accounts
- soft loans received by local authorities (perhaps from Government agencies or European Economic Community agencies).

##### *Soft loans advanced*

- 7.1.4.3 The fair value of a loan advanced at nil interest rate or below the prevailing market rate shall be estimated as the present value of all future cash receipts discounted using the prevailing market rate of interest for a similar instrument and for an organisation with a similar credit rating. The sum by which the amount lent exceeds the fair value of the loan shall be charged to the surplus or deficit on provision of services as grant expenditure.

- 7.1.4.4 In subsequent accounting the loan's effective interest rate (ie the interest used to determine the net present value of the soft loan) shall to be used to

determine the amortised cost of the loan. This will result over the term of the loan in the carrying amount of the loan being written up to the amount it would have been immediately before repayment if it had not been accounted for as a soft loan; and interest income being credited to surplus or deficit on provision of services over the term of the loan in excess of the contractual interest equal to the write-down of the soft loan on initial recognition.

- 7.1.4.5 It may be difficult to identify the prevailing rate of interest appropriate to the borrower in some cases. An acceptable approach to determining the prevailing interest rate would be to base it on the authority's borrowing cost plus an allowance for the risk that the loan will not be fully repaid (ie the credit risk). Authorities may use other reasonable approaches to determining the prevailing interest rate.

*Regulation/statutory guidance on 'soft loans' advanced by an authority*

- 7.1.4.6 Soft loans advanced by a local authority are covered by the Local Authorities (Capital Financing and Accounting) (Amendment) (England) Regulations 2007, the Local Authorities (Capital Financing and Accounting) (Wales) (Amendment) Regulations 2007 and by guidance issued on 30 March 2007 under section 12 (2)(b) of the Local Government in Scotland Act 2003. Northern Ireland has not regulated on the matter. The regulations for England and Wales cover both soft loans on an authority's Balance Sheet on 31 March 2007 and soft loans advanced after 31 March 2007. The statutory guidance for Scotland covers only soft loans on an authority's Balance Sheet on 31 March 2007. The regulations for England and Wales provide that the amount taken to the General Fund in respect of all soft loans should be the contractual interest receivable. This is also the case in Scotland for loans that were on the Balance Sheet at 31 March 2007 but not for soft loans originated after 31 March 2007.

- 7.1.4.7 The difference between the amount charged or credited to the Surplus or Deficit on provision of services in accordance with the Code and the interest income (if any) required under the England, Wales and Scotland regulations/statutory guidance to be credited to the General Fund shall be debited or credited to the General Fund Balance with the double entry going to the Financial Instruments Adjustment Account such that the General Fund records the amount required by the applicable regulations or statutory guidance.

- 7.1.4.8 Reference is made in paragraphs 7.1.4.6 and 7.1.4.7 above and elsewhere in this chapter to amounts required to be taken to the General Fund Balance. For clarity reference to General Fund Balance includes the Housing Revenue Account Balance and requires the amount to be apportioned appropriately between the General Fund and Housing Revenue Account if an HRA is maintained.

*Soft loans made to a subsidiary*

- 7.1.4.9 Local authorities may sometimes make soft loans to subsidiary bodies consolidated into their Group Accounts. As with other soft loans the fair value shall be estimated as the present value of all future cash receipts

discounted using the prevailing market rate of interest for a similar instrument and for an organisation with a similar credit rating. However, the write-down to fair value shall not be taken to Surplus or Deficit on provision of services as in substance this is an additional investment by the local authority into its subsidiary. The difference between the loan amount and the fair value of the loan shall be accounted for as an investment in an authority's single entity Statement of Accounts.

#### *Soft loans receivable*

- 7.1.4.10 The fair value of the loan shall be determined as the net present value of the future cash payments discounted using the prevailing market rate of interest at which the authority could borrow for a loan with similar terms. The PWLB interest rate for a loan with similar terms shall be used to estimate the prevailing market rate of interest except where the authority can provide reliable evidence that it would be able to borrow at a lower rate of interest from another lender on arm's length terms. This will result in a lower figure for the fair value of the liability than the loan received, the difference shall be taken to Surplus or Deficit on the provision of services as grant receivable in accordance with Code section 3.1.x Government Grants [Note development of Government Grants section not completed].
- 7.1.4.11 Subsequent accounting will require the loan's effective interest rate to be used, which will be the same as the interest rate used to determine the net present value of the loan. This will result over the term of the loan in the carrying amount of the loan being written up to the amount it would have been if it had not been accounted for as a soft loan and interest expense over and above the contractual interest payable. The amount in excess of the contractual interest payable would be equal to the write-down of the carrying amount of the soft loan to fair value on initial recognition.

### **7.1.5 Classification of financial instruments**

#### *Overview of classifications*

- 7.1.5.1 The accounting treatment of a financial instrument subsequent to initial recognition depends on its classification on initial recognition. *IAS 39* recognises four classes of financial assets and two classes of financial liabilities:

#### Financial assets

- fair value through profit or loss
- loans and receivables
- available for sale
- held to maturity.

#### Financial liabilities:

- fair value through profit or loss
- amortised cost.

- 7.1.5.2 There is also one type of financial asset that falls outside the regular classifications above, which is an equity instrument for which a reliable fair value cannot be determined.

*Designation of the category of a financial instrument*

- 7.1.5.3 Under *IAS 39*, subject to restrictions, it is in certain circumstances permitted to 'designate' a financial instrument to a different category to the one to which it inherently belongs. For example, designation of available-for-sale financial assets to at fair value through profit or loss, or alternatively to as held to maturity, are common 'designations'. The Code does not permit authorities to 'designate' financial instruments since it would make different authorities' financial statements less comparable. All financial instruments should be classified on initial recognition in accordance with their inherent characteristics. Under *IAS 39*, held to maturity is an entirely discretionary category of financial asset, ie it is one to which qualifying financial assets are permitted to be designated but no financial asset is required to be classified. Since the Code does not permit designation, no financial assets shall be classified as held to maturity.

*Loans and receivables*

- 7.1.5.4 If financial asset meets the requirement to be classified as loans and receivables it shall be classified as loans and receivables. Loans and receivables have two defining characteristics. They:
- have fixed or determinable payments, and
  - are not quoted in an active market.
- 7.1.5.5 An equity instrument cannot be categorised as loans and receivables since it does not have fixed or determinable payments. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transaction on an arm's-length basis.
- 7.1.5.6 Usually loans and receivables arise when money, goods or services are provided to a debtor with no intention of trading the receivable. However, financial assets that have been acquired rather than originated by an authority can also be loans and receivables. A loan asset acquired as a participation in a loan from another lender shall also be included in this category, as shall loan assets purchased by the authority that would otherwise meet the definition.

*Available-for-sale*

- 7.1.5.7 All financial assets that are not required by the Code to be classified as at fair value through profit or loss or as loans and receivables should be classified as available-for-sale. The available-for-sale category includes:
- equity investments other than those for which a reliable fair value cannot be determined (unless required to be accounted for under

Chapter 9 Group Accounts of the Code)

- other investments traded in an active market.

*Financial liabilities at amortised cost*

- 7.1.5.8 Financial liabilities at amortised cost constitute the residual category similar to the available for sale category of financial assets. All liabilities other than liabilities held for trading shall be classified automatically into this category.

*Financial assets and liabilities at fair value through profit or loss*

- 7.1.5.9 The category at fair value through profit or loss can apply to both financial assets and financial liabilities. A financial instrument that is 'held for trading' shall be classified as at fair value through profit or loss. The definition is met if it is:
- (a) acquired or incurred principally for the purpose of selling or repurchasing it in the near term, or
  - (b) 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, or
  - (c) a derivative.
- 7.1.5.10 'Acquired or incurred principally for the purpose of selling or repurchasing in the near term', would usually involve frequent buying and selling of financial instruments but this is only an indication that trading may be occurring. The key test is whether financial instruments are being used with the objective of generating a profit from short-term fluctuations in price or dealer's margin. Active management of financial instruments does not necessarily amount to trading although it would be an indication of it. The application and implementation guidance contained in paragraphs AG14–AG15 and B.11–B.12 of *IAS 39* shall be applied in deciding whether a financial instrument is being held for trading.
- 7.1.5.11 A portfolio is a group of financial instruments that are managed together. 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.
- 7.1.5.12 The Code in accordance with *IAS 39* requires derivatives to be regarded as 'held for trading' irrespective of the purpose for which the entity holds the instrument. Derivatives are covered in more detail in paragraphs 7.1.6.1–7.1.6.5).
- 7.1.5.13 It is understood that most authorities do not hold financial instruments that the Code would require to be classified at fair value through profit or loss, and that those that do would usually only hold them to an insignificant extent. However, authorities shall assess whether they have financial instruments at fair value through profit or loss.

## 7.1.6 Derivatives and Embedded Derivative

### *Derivatives*

- 7.1.6.1 All derivatives not accounted for under hedge accounting shall be classified as at fair value through profit or loss and changes in fair value shall be recognised in Surplus or Deficit on provision of services. Derivatives that are part of an effective cash flow or net investment hedging relationship are not covered in detail by the Code and shall be accounted for in accordance with the hedge accounting requirements of *IAS 39*.
- 7.1.6.2 A derivative is a financial instrument with all three of the following characteristics:
- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying')
  - (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and
  - (c) it is settled at a future date.
- 7.1.6.3 Typical examples of derivatives are futures and forwards, swap and option contracts. Many derivatives are settled net rather than by delivery of the underlying financial instrument but derivatives include contracts that are settled gross by delivery of the underlying financial instrument such as a forward contract to purchase a security. The application guidance contained in paragraphs AG9 to AG12a of *IAS 39* shall be applied when considering whether a financial instrument is a derivative.
- Forward purchase contract
- 7.1.6.4 Although it is understood to be rare for local authorities to hold derivatives to a significant extent it is understood some authorities use forward contracts to purchase investment assets. Such forward contracts are 'derivatives' between the trade and settlement date and therefore shall be classified as at fair value through profit or loss.
- 7.1.6.5 On the trade date the fair value of the derivative will be nil but if the fair value of the 'underlying' (ie the financial asset) increases the derivative will have a positive value and if it decreases it will have a negative value. The derivative is settled on the settlement date by the delivery of the financial asset and payment of the consideration. The financial asset shall be recognised at fair value on the settlement date. 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) shall be taken to Surplus or Deficit on provision of services. If a forward contract is open at the year-end the gain or loss on the forward contract is taken to

Surplus or Deficit on provision of services. If the forward contract 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.

*Embedded derivatives*

7.1.6.6 Some financial instruments are hybrid, in that for accounting purposes they are considered to comprise a non-derivative host contract that contains an embedded derivative. An embedded derivative causes some or all of the cash flows that would otherwise be required by the contract to be modified. Some embedded derivatives are required to be separated from the host contract and accounted for as derivatives. Other embedded derivatives are not required to be separated from the host contract and the instrument should be accounted for as a single financial instrument. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

7.1.6.7 An embedded derivative shall be separated from the host contract and accounted for as a derivative under the Code if, and only if:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated the host contract shall be accounted for under this Chapter if it is a financial instrument, and in accordance with other appropriate Chapters of the Code if it is not a financial instrument.

7.1.6.8 Eleven examples of embedded derivatives that shall or shall not be required to be separated from the host instrument and accounted for separately since the embedded derivative does not have characteristics and risks which are closely related to the host contract can be found in Section C of the implementation guidance of *IAS 39*. This implementation guidance shall be considered when an authority determines whether an embedded derivative is required by the Code to be separated and accounted for separately.

7.1.6.9 Many authorities have lender option borrower option loan debts, which are commonly referred to as 'LOBOs'. The key characteristics of a LOBO are that the host contract is a loan with the rate of interest payable specified for the whole term of the contract. However, there is an option that allows the lender to increase the interest charge by any amount chosen at specified option exercise dates. If the lender increases the interest rate, the borrower has an option to repay the loan at the amount of the principal

outstanding. If the borrower accepts the increased interest rate, it becomes the host contract's interest rate for the remainder of its term (subject to revision at the next option exercise date). The options embedded in a LOBO would not usually be required to be separately accounted for under *IAS 39* and such instruments shall be accounted for on this basis unless on considering the terms of the instrument the authority concludes that *IAS 39* would require the options to be accounted for separately.

### 7.1.7 Hedge Accounting

7.1.7.1 Entities carry out hedging activities in order to limit their exposure to different financial risks such as currency risk and interest rate risk. These activities commonly consist of entering into a derivative contract with a counter party to eliminate or limit risk. The term hedging refers to a risk management strategy, while hedge accounting refers to the accounting methods entities may choose to reflect hedging activities in their financial statements. Under *IAS 39*, application of hedge accounting is not mandatory and in principle can be chosen on a transaction-by-transaction basis.

7.1.7.2 The accepted view is that currently local authorities seldom use such hedging techniques. However, if an authority undertakes hedging activities these shall be accounted for in accordance with the requirements of *IAS 39* and presented and disclosed in accordance with the requirements of *IAS 32* and *IFRS7*.

### 7.1.8 Definitions

7.1.8.1 The following terms are used in this Code with the meanings specified:

A ***financial asset*** is any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
  - (i) to receive cash or another financial asset from another entity; or
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity;
- (d) a contract that will or may be settled in the entity's own equity instruments and is:
  - (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

- (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

**Note:** in practice (d) is not applicable to local authorities as they do not issue equity instruments.

A **financial liability** is any liability that is:

- (a) a contractual obligation:
  - (i) to deliver cash or another financial asset to another entity; or
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity;
- (b) a contract that will or may be settled in the entity's own equity instruments and is:
  - (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

**Note:** in practice (b) is not applicable to local authorities as they do not issue equity instruments.

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

**Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A **financial asset or financial liability at fair value through profit or loss** is a financial asset or financial liability that meets the following conditions. It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

- (a) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

- (b) on initial recognition 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; or
- (c) it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

**Note:** IAS 39 also permits an entity to designate financial instruments that do not meet the above tests as at fair value through profit or loss (subject to meeting certain conditions). The Code requires all financial instruments to be classified to the category to which they intrinsically belong and consequently does not permit authorities to 'designate' an instruments category.

***Held-to-maturity investments*** are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity.

**Note:** no financial assets are required to be classified as held-to-maturity, it is an optional 'designation' (subject to meeting strict conditions) under IAS 39. The Code does not permit financial assets to be designated as held-to-maturity.

***Loans and receivables*** are non-derivative financial assets with fixed or determinable payments 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.

An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

***Available-for-sale financial assets*** are 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.

**Note:** The Code does not permit designation of financial instruments and therefore under the Code available-for-sale financial assets are those non-derivative financial assets not meeting the *IAS 39* requirements to be classified as loans and receivables, or financial assets at fair value through profit or loss.

***A financial guarantee contract*** is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

*Definitions relating to recognition and measurement*

The ***amortised cost of a financial asset or financial liability*** is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The ***effective interest method*** is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The ***effective interest rate*** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see *IAS 18 Revenue*), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

***Derecognition*** is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

***Fair value*** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A ***regular way purchase or sale*** is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

***Transaction costs*** are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

## Transition arrangements – Financial Instruments

The accounting standards on which the 2009 SORP is based are converged standards: there are expected to be no issues arising from financial instruments on transition to the Code.

## **7.2 Accounting for Financial Liabilities after Initial Recognition**

### **7.2.1 Introduction**

7.2.1.1 This section of the Code covers:

- (a) Subsequent measurement of the balance sheet carrying amount of financial liabilities
- (b) Determination of the expense or income to be recognised in the Surplus or Deficit on provision of services for the accounting period.
- (c) Financial Guarantee contracts.

7.2.1.2 The accounting treatment of a financial liability subsequent to initial recognition depends on its classification on initial recognition. The Code requires financial liabilities to be classified into one of two categories of financial liabilities (see paragraphs 7.1.5.1 and 7.1.5.8–7.1.5.13):

- amortised cost
- fair value through profit or loss.

### **7.2.2 Subsequent accounting of financial liabilities carried at amortised cost**

*Amortised cost using the effective interest rate method*

7.2.2.1 Amortised cost using the effective interest rate can apply to both financial liabilities and financial assets (eg loans and receivables) and the following seven paragraphs apply to both financial liabilities and financial assets carried at amortised cost.

7.2.2.2 The **effective interest method** is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

7.2.2.3 The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts.

7.2.2.4 Short duration receivables or payables with no stated interest rate shall be measured at original invoice amount.

7.2.2.5 The determinable cash flows of a variable rate financial instrument shall be

re-estimated to reflect movements in interest paid/received on the instrument.

- 7.2.2.6 For most loan debts and investments there will be transaction costs and the Code requires that these are applied to adjust the financial instrument's initial carrying amount with the result that they are amortised to Surplus or Deficit on provision of services over the life of the financial instrument. However, where judged immaterial transaction costs may be charged immediately to Surplus or Deficit on provision of services.

*Expected life and cash flows of a financial instrument*

- 7.2.2.7 The effective interest rate used to determine the finance costs or income receivable of a financial instrument carried at amortised cost and its carrying amount subsequent to initial recognition is based on discounting the estimated cash flows and estimated life of the instrument rather than on its contractual cash flows and contractual life. There is a presumption that the cash flows and expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments) shall be used.
- 7.2.2.8 A Lender Option Borrower Option (LOBO) loan would normally be such a "rare case" since at origination of the loan it would not usually be possible to estimate reliably the instrument's expected cash flows or expected life. The contractual life and contractual cash flows shall be used as the expected life of a LOBO when calculating the effective interest rate on initial recognition, unless on considering the contractual terms of the instrument the authority concludes it is able to estimate reliably the expected cash flows and expected life.

*Revision of expected life and cash flows of a financial instrument*

- 7.2.2.9 If an authority revises its estimates of payments or receipts, it shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The authority recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in Surplus or Deficit on provision of services. However, it should be noted that where the instrument is accounted for under the hedging accounting requirements the revised effective interest rate is used. In such situations the matter is accounted for in accordance with *IAS 39* (see paragraphs 92 and AG8 of *IAS 39*).

**7.2.3 Derecognition of a financial liability**

- 7.2.3.1 Derecognition is the term used for the removal of an asset or liability from the Balance Sheet. A financial liability shall be removed from the Balance Sheet when it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expires. The difference between the

carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid including any non-cash assets transferred or liabilities assumed, shall be recognised in Surplus or Deficit on provision of services.

*Exchange between an existing borrower and lender*

- 7.2.3.2 An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.
- 7.2.3.3 However, where the terms of the loan debt exchanged are **not substantially** different or the modification of the terms of an existing liability is **not substantial**, the loan debt or financial liability shall not be accounted for as an extinguishment and any costs or fees paid or received (normally referred to as premiums and discounts by local authorities) adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability. The exchange of loan instruments and associated settlement of any fees or costs incurred shall be simultaneous (ie take place on the same day). However, net settlement is not required as long as any payments between the lender and borrower are made on the same day.
- 7.2.3.4 The terms of a loan exchange between an existing borrower and lender or the modification of the terms of a financial liability are 'substantially different' or 'substantially modified' if the present value of the net cash flows under the new terms, including any fees paid net of any fees received (normally referred to as premiums and discounts by local authorities), is at least 10% different from the discounted present value of the remaining cash flows under the original loan debt or original terms of the financial liability. In calculating the present value of these cash flows the original effective interest rate of the old loan debt or unmodified financial liability shall be used.

*Regulations/statutory guidance on premiums and discounts*

- 7.2.3.5 Premiums and discounts incurred on the early repayment of loan debt are covered by the Local Authorities (Capital Financing and Accounting) (Amendment) (England) Regulations 2007, the Local Authorities (Capital Financing and Accounting) (Wales) (Amendment) Regulations 2007 and by statutory guidance issued on 30 March 2007 under section 12(2)(b) of the Local Government in Scotland Act 2003. There are no regulations for Northern Ireland. The various regulations/statutory guidance of England, Wales and Scotland allow (or in the case of discounts require) any premiums and discounts arising from 1 April 2007 that are required under the 2007 SORP to be taken immediately to the Surplus or Deficit on provision of services to be amortised to 'revenue' (ie the General Fund) over the various periods specified in the above regulations/statutory guidance or in the case of premiums such shorter period as the authority may choose.

7.2.3.6 The Surplus or Deficit on provision of services shall reflect the Code requirements. The effect of applying the regulations/statutory guidance shall be accounted for through the Movement on Reserves Statement. The difference between the amount charged or credited in the year to the Surplus or Deficit on provision of services in accordance with the Code and the amount charged or credited to the General Fund in accordance with regulations/statutory guidance should be debited or credited to the General Fund Balance with the double entry going to the Financial Instruments Adjustment Account such that the General Fund is charged or credited with the amount that accords with the applicable regulations/statutory guidance.

#### **7.2.4 Financial Guarantee Contracts**

7.2.4.1 Local authorities sometimes give financial guarantees that require them to make specified payments to reimburse the holder of a debt if the debtor fails to make payment when due in accordance with the terms of the contract. Commercial organisations may charge a fee for accepting the risk involved in giving such financial guarantees but local authorities enter into such arrangements for policy rather than commercial reasons and do not usually receive a fee.

7.2.4.2 The financial guarantee contract shall be initially recognised at fair value. If the contract was issued in a stand-alone arm's-length transaction to an unrelated party, its fair value at inception will be the premium received unless there is evidence that this is not a reliable estimate of fair value. If no premium is received the fair value of the financial guarantee contract at inception shall be estimated by considering the probability of the guarantee being called and the likely amount payable under the guarantee.

7.2.4.3 Subsequently a financial guarantee shall be measured at the higher of the amount recognised initially and the amount determined in accordance with *IAS 37 Provisions, Contingent Liabilities and Assets* less when appropriate cumulative amortisation. Therefore, the carrying amount of the financial guarantee would remain at the original amount estimated at inception (less cumulative amortisation) unless payment under the guarantee becomes probable at which point the amount of the liability shall be determined in accordance with *IAS 37*.

7.2.4.4 The entries on initial recognition would be to recognise the liability by crediting Financial Guarantee Liabilities and to charge the loss to Surplus or Deficit on provision of services. If the amount determined in accordance with *IAS 37* becomes greater than the carrying amount, the carrying amount should be increased to this amount. The movements in the carrying amount of the financial guarantee after initial recognition whether from subsequent re-measurement in accordance with *IAS 37* or from amortisation of the liability in accordance with *IAS 39* shall be debited or credited to Surplus or Deficit on provision of services. Any consideration received for granting the financial guarantee should be credited to Surplus or Deficit on provision of services.

## **7.3 Accounting for Financial Assets after Initial Recognition**

### **7.3.1 Introduction**

7.3.1.1 This section of the Code covers:

- (a) Subsequent measurement of the balance sheet carrying amount of financial assets.
- (b) Determination of the income or expenditure to be recognised in the Comprehensive Income and Expenditure Statement for the accounting period.
- (c) Impairment of financial assets.
- (c) Derecognition of financial assets.

7.3.1.2 The accounting treatment of a financial asset after initial recognition (ie how subsequent carrying value is measured and gains and losses recognised) depends on its classification on initial recognition. The Code requires financial assets to be classified into one three categories of financial assets (see paragraphs 7.1.5.1–7.1.5.7):

- Loans and receivables
- Available for sale
- At fair value through profit or loss.

7.3.1.3 There is also one type of financial asset that falls outside the regular classifications above, which is an equity instrument for which a reliable fair value cannot be determined.

### **7.3.2 Subsequent measurement of financial assets and determination of the amounts to be recognised in the Comprehensive Income and Expenditure Statement**

#### *Loans and receivables*

7.3.2.1 The carrying amount of loans and receivables and the interest income receivable are measured following initial recognition at amortised cost using the effective interest rate method (see paragraphs 7.2.2.1–7.2.2.6). Interest receivable, impairment losses and the gain or loss on derecognition are taken to the Surplus or Deficit on provision of services. The impairment and derecognition of loans and receivables are dealt with in paragraphs 7.3.3.1–7.3.3.6, which covers all categories of financial assets

7.3.2.2 Short-duration receivables with no stated interest rate should be measured at original invoice amount.

#### *Available-for-sale financial assets*

7.3.2.3 After initial recognition the carrying amount of an available-for-sale financial asset shall be measured at its fair value, without any deduction for transaction costs that would be incurred on sale or other disposal. The following hierarchy shall be used in determining a reliable measure of a financial instrument's fair value on re-measurement (the hierarchy also applies to financial assets at fair value through profit or loss.):

(a) *Active Market – Quoted Market Price* - Published price quotations in an active market are the best evidence of fair value, and if available shall be used to measure the financial instrument. Where more than one price is quoted, the 'bid' price shall be used.

(b) *No Active Market – Valuation Techniques* - If the market for a financial instrument is not active, fair value shall be established by using a valuation technique. Valuation techniques include:

- recent market transactions
- reference to a transaction that is substantially the same
- discounted cash flows and option pricing models.

An acceptable valuation technique incorporates all factors that market participants would consider in setting a price, and shall be consistent with accepted economic methodologies for pricing financial instruments.

(c) *No Active Market – Equity Instruments* - normally it is possible to estimate the fair value of an equity instrument that has been acquired from an outside party. However, if the range of reasonable fair value estimates is significant, and no reliable estimate can be made, the instrument shall be measured at cost less impairment.

7.3.2.4 The gain or loss arising from a change in the fair value of an available-for-sale financial asset shall be recognised in Other Comprehensive Income and Expenditure and taken to the Available-for-Sale Reserve except for impairment losses and foreign exchange gains and losses, which shall be recognised in Surplus or Deficit on provision of services. The calculation of the gain or loss shall be based on the 'clean' price of the instrument, ie its fair value excluding accrued interest, and the amortised cost of the instrument also excluding accrued interest.

7.3.2.5 When an available-for-sale financial 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 Surplus or Deficit on provision of services.

7.3.2.6 Interest on an available-for-sale financial asset shall be calculated using the effective interest rate method and credited to Surplus or Deficit on provision of services. Dividends on an available-for-sale equity instrument shall be recognised in Surplus or deficit on provision of services when the right to receive payment is established.

*At fair value through profit or loss*

- 7.3.2.7 After initial recognition the carrying amount of a financial asset at fair value through profit or loss shall be measured at its fair value, without any deduction for transaction costs that would be incurred on sale or other disposal. See paragraph 7.3.2.3 on how fair value shall be estimated. Changes in the fair value of a financial asset at fair value through profit or loss shall be recognised in Surplus or Deficit on provision of services.

*Unquoted equity investments for which a reliable fair value cannot be established*

- 7.3.2.8 One type of financial asset falls outside the standard *IAS 39* asset categories, which is unquoted equity instruments for which a reliable fair value cannot be established. Except for investments in subsidiaries and associates, which are covered by Chapter 9 of the Code, these should be measured subsequent to initial recognition at cost. Fair value cannot be reliably estimated when the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed. There are well-established techniques for valuing unquoted companies and it will often be possible to estimate fair value. Dividends shall be recognised in Surplus or Deficit on provision of services when the right to receive payment is established.

**7.3.3 Impairment and uncollectability of financial assets**

- 7.3.3.1 A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of a past event that occurred subsequent to the initial recognition of the asset. Expected losses as a result of future events, no matter how likely, shall not be recognised. The downgrade of the credit rating of a creditor is not of itself objective evidence of impairment, although it may be when considered with other information. Events that provide objective evidence of impairment include the following:

- (a) Significant financial difficulty of the creditor.
- (b) A breach of contract, such as a default or delinquency in interest or principal payments.
- (c) The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider.
- (d) It becoming probable that the borrower will enter bankruptcy or other financial reorganisation
- (e) The disappearance of an active market for that financial asset because of financial difficulties.
- (f) 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:

- (i) adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments), or
- (ii) 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 area).

7.3.3.2 At each Balance Sheet date an assessment shall be made of whether there is objective evidence that any financial asset or group of financial assets may be impaired. An assessment shall first be made of whether evidence of impairment exists individually for financial assets that are individually significant. Then an assessment of impairment shall be made individually or collectively for financial assets that are not individually significant.

*Collective evaluation of impairment*

7.3.3.3 If it is determined that no objective evidence of impairment exists for an individually assessed financial asset, the asset shall be included in a group of financial assets with similar credit risks and collectively assessed for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised shall not be included in a collective assessment of impairment. When information becomes available that specifically identifies losses on individually impaired assets in a group, those assets shall be removed from the group.

7.3.3.4 For the purposes of a collective evaluation of impairment, financial assets shall be grouped on the basis of similar credit risk characteristics. Those characteristics shall be relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. Relevant characteristics would normally include asset type (eg trade debtors, council tenant rent debtors and unsecured loans might be separate asset types) and past-due status (eg age analysis of debtor balance).

7.3.3.5 Future cash flows in a group of financial assets that are collectively evaluated for impairment shall be estimated on the basis of the contractual cash flows of the assets in the group and historical loss experience for assets with credit risk characteristics similar to those in the group. Where current information indicates that the historical loss experience does not properly reflect current conditions, the historical loss experience shall be adjusted appropriately.

*Impairment of financial assets carried at amortised cost*

7.3.3.6 If there is objective evidence that impairment of a financial asset carried at amortised cost has been incurred and the carrying amount exceeds its estimated recoverable amount, then the asset is impaired. The recoverable amount is the present value of the expected future cash flows discounted at the instrument's original effective interest rate. Sometimes the effective interest rate would be zero, ie in the case of most trade debtors, which

would not usually bear interest. The carrying amount shall be reduced to its recoverable amount either directly or through the use of an allowance account. The amount of the loss shall be included in Surplus or Deficit on provision of services.

*Impairment of available-for-sale financial assets*

7.3.3.7 If there is objective evidence of impairment of an available-for-sale financial asset, the cumulative net loss that has previously been recognised in Other Comprehensive Income and Expenditure shall be removed from the Available-for-Sale Reserve and recognised in the Surplus or Deficit on provision of services, even though the asset has not been sold. The cumulative net loss is the difference between amortised acquisition cost and current fair value less any impairment loss previously recognised in Surplus or Deficit on provision of services.

7.3.3.8 Impairments of investments in equity securities shall not be reversed and an increase in fair value subsequent to its impairment shall be recognised in Other Comprehensive Income and Expenditure and taken to the Available-for-Sale Reserve. However, if the fair value of an investment in an available-for-sale debt instrument increases subsequent to its impairment and the increase can be objectively related to an event occurring after the loss was recognised, the loss shall be reversed through Surplus or Deficit on provision of services.

*Impairment of financial assets carried at cost*

7.3.3.9 If there is objective evidence of impairment of an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, the amount of the impairment loss is the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar asset. The loss shall be charged to the Surplus or Deficit on provision of services. Such impairment losses shall not be reversed.

*Interest income after impairment recognition*

7.3.3.10 Once a financial asset or group of similar financial assets has been written down as a result of an impairment loss, interest income shall be thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

**7.3.4 Derecognition of a financial asset**

7.3.4.1 Establishing when a financial asset should be derecognised is straightforward in most cases. Normally a financial asset is derecognised when the contractual rights to the cash flows from the financial asset have expired or have been transferred. However, the requirements are complex where an authority retains the right to receive cash flows or any of the risks and rewards of the financial asset following the transfer. In such cases the arrangement should be carefully analysed in accordance with paragraphs 15 to 37 and AG36 to AG52 of *IAS 39* to determine whether and to what extent

a financial asset should be derecognised and whether there are any new assets and liabilities to be recognised.

## **7.4 Financial Instruments – Disclosure and Presentation Requirements**

### **7.4.1 Introduction**

- 7.4.1.1 This section of Chapter 7 sets out the required disclosures and presentation of financial instruments. Hedge accounting disclosures are not covered. Hedge accounting, while permitted by the Code, would seldom be used by a local authority. Where an authority uses hedge accounting it shall include the presentation and disclosures required by *IAS 32* and *IFRS 7*. Those disclosures applicable only to entities that issue equity instruments are not covered in detail in the Code. In the very unlikely circumstance that a local authority issued a financial instrument which IFRS required to be accounted for as an equity instrument, the presentation and disclosures required by *IAS 32* and *IFRS 7* shall apply.
- 7.4.1.2 Part 1 of the section sets out the required disclosures of financial instruments. Its purpose is to require authorities to provide information in their financial statements that would enable users to evaluate:
- the significance of financial instruments for the authority's financial position and performance
  - the nature and extent of risks arising from financial instruments to which the authority was exposed and how the authority manages those risks.
- 7.4.1.3 The extent of disclosure required depends on the extent of the authority's use of financial instruments and of its exposure to risk. To the extent that required information is presented on the face of the financial statements, it is unnecessary to repeat it in the notes. Disclosures include a combination of narrative descriptions and quantified data, as appropriate to the nature of the instruments and their relative significance to the authority.
- 7.4.1.4 Determining the level of detail to be disclosed about particular financial instruments requires the exercise of judgment taking into account the relative significance of those instruments. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users and obscuring important information as a result of too much aggregation. For example, when an authority is party to a large number of financial instruments with similar characteristics and no single contract is individually material, a summary by classes of instruments is appropriate.
- 7.4.1.5 The accounting standard underlying the Code's financial instruments presentation requirements is *IAS 32 Financial Instruments Presentation*. However, much of the standard covers matters that are of relevance only to entities that issue equity instruments; and the Code therefore does not cover in detail paragraphs 15 to 41 of *IAS 32*, which deal with:
- (a) Classifying financial instruments issued as liabilities or equity (paragraphs 15 – 27).
  - (b) Compound financial instruments' issued (ie financial instruments that contain both a liability and equity component) (paragraphs 28 – 32)

- (c) 'Treasury shares' (ie the reacquisition of its own equity instruments by an entity) (paragraphs 33 – 34)
- (d) Interest, dividends, losses and gains, which deals with distinguishing dividend type distribution to equity holders (which shall be debited to equity) from interest payments to holders of an entity's liability instruments, which shall be recognised in profit or loss (paragraphs 35 – 41).

7.4.1.6 If the above matters were to become relevant to accounting statements prepared under this Code, the matter shall be accounted for in accordance with *IAS 32*.

## ***PART 1 – DISCLOSURES***

### **7.4.2 Significance of financial instruments for financial position and performance**

7.4.2.1 An authority shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance. The disclosures required are:

#### **Balance Sheet disclosures**

##### *Categories of financial assets and financial liabilities*

7.4.2.2 The carrying amounts of each of the following categories shall be disclosed either in the balance sheet or in the notes to the accounts:

- (a) loans and receivables
- (b) available-for-sale financial assets
- (c) unquoted equity investment at cost
- (d) financial assets at fair value through profit or loss (if any)
- (e) financial liabilities at amortised cost
- (f) financial liabilities at fair value through profit or loss (if any).

##### *Reclassification*

7.4.2.3 If an authority has reclassified a financial asset as one measured:

- (a) at cost or amortised cost, rather than at fair value
- (b) at fair value, rather than at cost or amortised cost

it shall disclose the amount reclassified into and out of each category and the reason for that reclassification.

#### *Derecognition*

- 7.4.2.4 If an authority has transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition it shall disclose for each class of such financial assets:
- (a) the nature of the assets
  - (b) the nature of the risks and rewards of ownership to which the authority remains exposed
  - (c) when the authority continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities, and
  - (d) when the authority continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the authority continues to recognise, and the carrying amount of the associated liabilities.

#### *Collateral*

- 7.4.2.5 When an authority holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose:
- (a) the fair value of the collateral held
  - (b) the fair value of any such collateral sold or repledged, and whether the authority has an obligation to return it
  - (c) the terms and conditions associated with its use of the collateral.

#### *Allowance account for credit losses*

- 7.4.2.6 When financial assets are impaired by credit losses and the authority records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.

#### *Defaults and breaches*

- 7.4.2.7 For loans payable recognised at the end of the reporting period, an authority shall disclose:
- (a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable
  - (b) the carrying amount of the loans payable in default at the reporting date, and

- (c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

7.4.2.8 If, during the period, there were breaches of loan agreement terms other than those described in paragraph 7.4.2.7, an entity shall disclose the same information as required by paragraph 7.4.2.7 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).

### **Coprehensive Income and Expenditure Statement disclosures**

#### *Items of income, expense, gains or losses*

7.4.2.9 An authority shall disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:

- (a) net gains or net losses on:
  - (i) financial assets or financial liabilities at fair value through profit or loss (if any)
  - (ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised in Other Comprehensive Income and Expenditure during the period and the amount reclassified from Other Comprehensive Income and Expenditure to the Surplus or Deficit on provision of services for the period
  - (iii) loans and receivables
  - (iv) financial liabilities measured at amortised cost.
- (b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or 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; and
  - (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*; and
- (e) the amount of any impairment loss for each class of financial asset.

#### *Accounting policies*

7.4.2.10 An authority shall disclose, in its accounting policies disclosure note, 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*

- 7.4.2.11 For each class of financial assets and financial liabilities an authority shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.
- 7.4.2.12 In disclosing fair values, an authority shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the balance sheet.
- 7.4.2.13 An authority shall disclose:
- (a) The methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an authority discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates.
  - (b) 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.
  - (c) 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 entity shall state this fact and disclose the effect of those changes. For this purpose, significance shall be judged with respect to surplus or deficit, and total assets or total liabilities, or, when changes in fair value are recognised in equity, total equity.
  - (d) if (c) applies, the total amount of the change in fair value estimated using such a valuation technique that was recognised in surplus or deficit during the period.
- 7.4.2.14 If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs AG74–AG79 of *IAS 39*). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (ie the fair value of the consideration given or received), unless conditions described in paragraph AG76 of *IAS 39* are met. It follows 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 entity shall disclose, by class of financial instrument:

- (a) its accounting policy for recognising that 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
- (b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

7.4.2.15 Disclosures of fair value are not required:

- (a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;
- (b) for an investment in equity instruments that do not have a quoted market price in an active market because its fair value cannot be measured reliably; or
- (c) 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.

7.4.2.16 In the cases described in 7.4.2.16 (b) and (c), an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:

- (a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
- (b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
- (c) information about the market for the instruments;
- (d) information about whether and how the entity intends to dispose of the financial instruments; and
- (e) 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.

### **7.4.3 Nature and extent of risks arising from financial instruments**

7.4.3.1 An authority shall disclose information that enables users of its financial

statements to evaluate the nature and extent of risks arising from financial instruments to which the authority is exposed at the end of the reporting period and how they have been managed. These risks typically include, but are not limited to, credit risk, liquidity risk and market risk.

*Qualitative disclosures*

7.4.3.2 For each type of risk arising from financial instruments, an authority shall disclose:

- (a) its exposures to risk and how they arise
- (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk, and
- (c) any changes in (a) or (b) from the previous period.

*Quantitative disclosures*

7.4.3.3 For each type of risk arising from financial instruments, an authority shall disclose:

- (a) summary quantitative data about its exposure to that risk at the reporting date. This disclosure shall be based on the information provided internally to key management personnel of the authority, for example the authority's finance committee or chief executive officer; and
- (b) concentrations of risk if not apparent from (a).

7.4.3.4 If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an authority's exposure to risk during the period, an authority shall provide further information that is representative.

*Credit risk*

7.4.3.5 An authority shall disclose by class of financial instrument:

- (a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements
- (b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements
- (c) information about the credit quality of financial assets that are neither past due nor impaired, and
- (d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

*Financial assets that are either past due or impaired*

7.4.3.6 An authority shall disclose by class of financial asset:

- (a) an analysis of the age of financial assets that are past due as at the reporting date but not impaired
- (b) an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the authority considered in determining that they are impaired, and
- (c) for the amounts disclosed in (a) and (b), a description of collateral held by the authority as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

*Collateral and other credit enhancements obtained*

7.4.3.7 When an authority obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the Code's criteria for recognition, an authority shall disclose:

- (a) the nature and carrying amount of the assets obtained; and
- (b) when the assets are not readily convertible into cash, its policies for disposing of such assets or using them in its operations.

*Liquidity risk*

7.4.3.8 An authority shall disclose:

- (a) a maturity analysis for financial liabilities that shows the remaining contractual maturities, and
- (b) a description of how it manages the liquidity risk inherent in (a).

*Market risk*

7.4.3.9 An authority shall disclose:

- (a) a sensitivity analysis for each type of market risk to which the authority is exposed at the reporting date, showing how the Surplus or Deficit on 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
- (b) the methods and assumptions used in preparing the sensitivity analysis, and
- (c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

## **PART 2 – PRESENTATION REQUIREMENTS**

### **7.4.4 Offsetting a financial asset and financial liability**

7.4.4.1 A financial asset and a financial liability shall be offset and the net amount presented in the Balance Sheet when, and only when, an authority:

- (a) currently has a legally enforceable right to set off the recognised amounts, and
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

7.4.4.2 In accounting for the transfer of a financial asset that does not qualify for derecognition an authority shall not offset the transferred asset and the associated liability.

### **7.4.5 Current liabilities**

7.4.5.1 An authority shall classify a liability as current when:

- (a) it expects to settle the liability in its normal operating cycle;
- (b) it holds the liability primarily for the purpose of trading;
- (c) the liability is due to be settled within twelve months after the reporting period; or
- (d) the authority does not have an unconditional right to defer the settlement of the liability for at least twelve months after the reporting period.

An authority shall classify all other liabilities as long term liabilities.

7.4.5.2 An authority shall regard its financial liabilities as due to be settled within 12 months after the Balance Sheet date, and classify them as current, even if:

- (a) the original term was for a period longer than 12 months, and
- (b) 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.

Examples are bank overdrafts, the portion of long-term financial liabilities due to be settled within 12 months after the Balance Sheet date including accrued interest, dividends payable, trade creditors and other creditors due to be settled within 12 months after the balance sheet date.

7.4.5.3 When an undertaking under a long-term loan agreement is breached on or before the Balance Sheet date with the effect that the liability becomes payable on demand, the liability is classified as current.

7.4.5.4 If an authority expects, and has the discretion, to refinance or roll over an

obligation for at least 12 months after the Balance Sheet date under an existing loan facility, it classifies the obligation as long term, even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the authority (for example, there is no agreement to refinance), the potential to refinance is not considered and the obligation is classified as current.