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Public Finance in Wessex Conference – 6 March 2019

David Ellis FCPFA
FAN Advisor
David.Ellis@cipfa.org

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What we will cover

- 2018/19 Accounts Closedown Issues and Future Code Changes
  - IFRS 9 *Financial instruments*
  - IFRS 15 *Revenue from contracts with customers*
  - Other Code Changes for 2018/19
  - IFRS 16 *Leases (2020/21)*
- Capital Strategies – learning points and future improvements

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IFRS 9 - The Guidance

IFRS 9 Financial Instruments: An Early Guide for Local Authority Practitioners

http://www.cipfa.org/policy-and-guidance/publications/i/ifrs-9-financial-instruments-an-early-guide-for-local-authority-practitioners

Update sheet – end of background section in the digital version

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Have you identified your Financial Instruments?

Contract

Agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law

gives rise to both …

Financial Asset

- cash
- an equity instrument of another entity
- a contractual right to:
  - receive cash or another financial asset from another entity
  - exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity

Financial Liability

- a contractual obligation to:
  - deliver cash or another financial asset to another entity
  - exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity

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Evidenced your 2018/19 Classifications?

amortised cost	The financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows	The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding
fair value through other comprehensive income	The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets	
fair value through profit or loss	All other combinations of business model and contractual cash flows	

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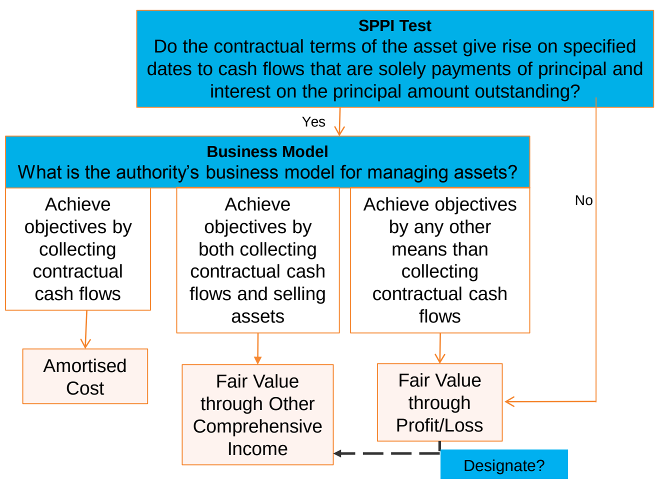
Evidenced your 2018/19 Classifications?



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Statutory Reversals for Financial Instruments

- Investment covered by the Prudential Framework
  - Applies to classification and impairment
  - Gains and losses <u>must</u> be reversed out
- Statutory override for pooled funds
  - Proper accounting practice
  - Statutory override 2018/19 to 2022/23
  - <u>All</u> pooled investments
  - Reverse gains/losses to '*an account established solely for the purpose of recognising fair value gains and losses*'
- No override for impairment allowance

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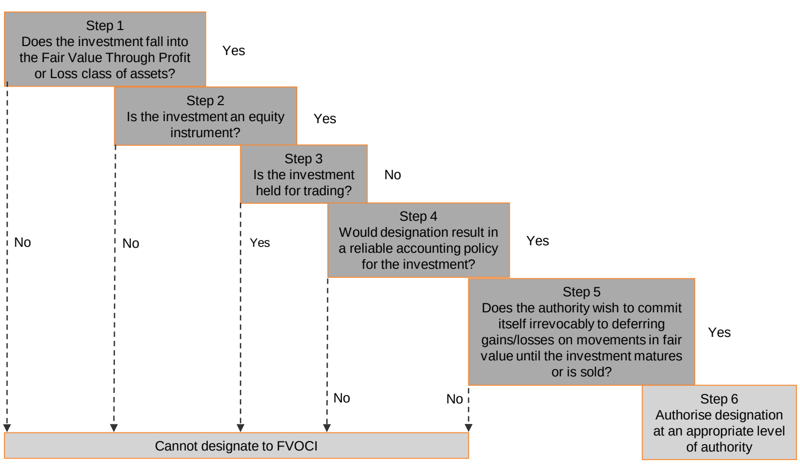
Designation of Equity Instruments



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Your Turn - Which Classification?

How should these investments initially be classified?

1. Loan to local football club – no expectation of sale

2. CCLA Property Investment

3. Shares in housing company to further 'housing for all' objective

4. Government gilts (10 year maturity but plan to cash in within 3 years as expecting interest rate to drop)

Amortised Cost

Fair Value through Other Comprehensive Income

Fair Value through Profit/Loss

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Impairment and Expected Credit Losses (ECL)

- Major conceptual change
  - incurred losses model replaced by expected losses model
- Incurred loss – needed evidence
- Expected loss - every SPPI asset
- Code exemptions 7.2.9.1
  - Local authorities shall not recognise a loss allowance for expected credit losses on a financial asset where the counterparty for a financial asset is central government or a local authority for which relevant statutory provisions prevent default

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Calculating Lifetime Expected Credit Losses

All contractual cash flows that are due to an authority in accordance with the contract for the instrument

Period 1 - £A
Period 2 - £B
Period 3 - £C
…

Discount factors based on the original effective interest rate

NPV of all contractual cash flows that are due X probability

less

All the cash flows that the authority expects to receive (including income from taking control of collateral)

Period 1 - £a
Period 2 - £b
Period 3 - £c
…

NPV of all cash flows that are expected to be received X probability

equals

Lifetime expected credit losses

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Lifetime v 12 Month ECLs

Different measures in different circumstances:

Lifetime	An estimate of the losses that could occur over the remaining term as a result of defaults, weighted by the probabilities that those defaults might take place
12 month	An estimate of the losses that could occur over the remaining term as a result of defaults that could happen in the next financial year, weighted by the probabilities that those defaults might take place
Cumulative change since recognition	The movement in lifetime ECLs since the asset was initially recognised (only for assets credit-impaired on initial recognition)

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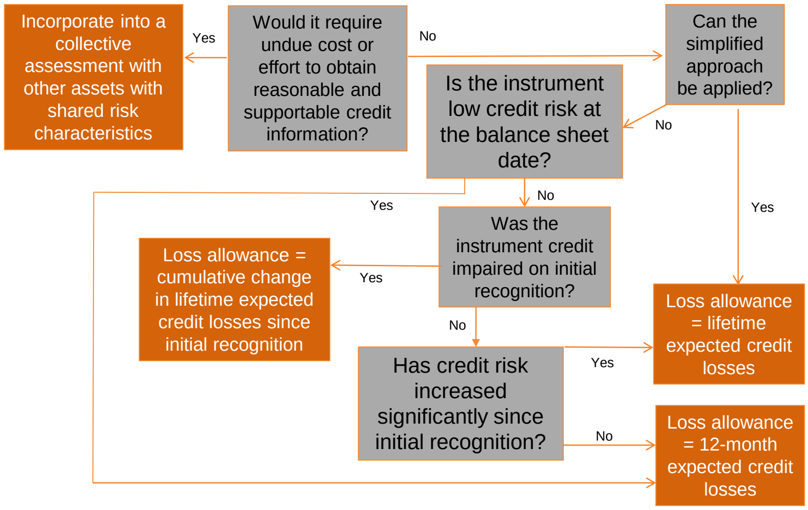
How will you measure expected losses?



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Collective Assessment - Example Approaches (1)

- Example: 5 x £100,000 loans, repayable in 3 years, fixed interest
- Probability of default
  - [possibility of default (over next 12 months or lifetime, as appropriate) x predicted % loss if a default takes place x carrying amount of loan]
  - 12 month probability of default 4%
  - Loss if default takes place 50%
  - Loss allowance £500,000 x 0.04 x 0.5 = £10,000
- Loss rate
  - [loss rate x carrying amount of loans]
  - Average 10% default rate with 75% loss of principal sum = 7.5% loss rate
  - Worsening economic environment projected increases loss rate to 9%
  - Loss allowance £500,000 x 0.09 = £45,000
- Provision matrix
  - cumulative product of the matrix (see next slide)

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Collective Assessment - Example Approaches (2)

Current – 0.5%
1-30 days past due – 2.5%
31-60 days past due – 4.5%
61-90 days past due – 7.5%
More than 90 days past due – 15%

	Gross carrying amount A £	**Loss Rate B**	**Lifetime expected credit losses A x B £**
Lifecycle stage			
Current	750,000	0.5%	3,750
1–30 days past due	200,000	2.5%	5,000
31–60 days past due	175,000	4.5%	7,875
61–90 days past due	160,000	7.5%	12,000
> 90 days past due	350,000	15.0%	52,500
		Loss allowance	**81,125**

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Impairment in Practice - Suggestions

	Approach?	Risk?
Government gilts, bonds, etc Loans to other authorities	Very secure. No credit risk recognised by Code.	No allowance – as per Code 7.2.9.1
Deposits with banks and building societies	Probably restricted to institutions with highest credit ratings. Treasury advisers will advise modest multipliers for 12 month ECLs.	Modest increase – possibly immaterial
Loan portfolios	Probably collective assessment – credit risk not monitored on routine basis. Possibly by provision matrix.	Possibility of significant increase
Loans to businesses and voluntary organisations	Individual assessment following through flowchart. Range of possible outcomes.	Risk of significant increases
Lease debtors	Possibility of collective assessment.	Risk of significant increases
Sundry debtors	Collective assessment by provision matrix.	Same as before

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Transition - Reclassification of Financial Assets

	amortised cost	fair value through other comprehensive income	fair value through profit or loss
loans and receivables		Eg, business model includes sale of assets Revalue to fair value using FI revaluation reserve	Eg, contractual payments not SPPI Revalue to fair value using General Fund Balance
available for sale	Eg, only available for sale because of quoted price Restate to amortised cost – adjustment should match balance on Available for Sale Reserve	Transfer to Financial Instrument Revaluation Reserve	Eg, change in default category Transfer Available for Sale Reserve balance to General Fund Balance

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Transition - Impairment

- Loss allowances as if IFRS 9 had always applied
- Low credit risk at 1 April 2018 = 12-month ECLs
- Instrument more than 30 days past due = presume lifetime ECLs
- Otherwise:
  - significant increase in risk at 1 April 2018 since recognition?
  - Default lifetime ECLs if cannot assess 'without undue cost or effort'

Disclosures and Materiality

- Two objectives - Enabling 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
- Combination of qualitative and quantitative
- Materiality – Code 7.3.1.4

IFRS 15 *Revenue from Contracts with Customers* – Introduction to Standard

- **IFRS 15 replaces, IAS 11 *Construction Contracts,* IAS 18 *Revenue* and related interpretations**
- **Scope: all contracts with customers except leases, financial instruments and insurance contracts**
- **Early version accompanied the 2017/18 Code**
- **Does not include council tax or non domestic rate income but does include income from implied contracts**

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IFRS 15 – the Five Step Approach to Recognition and Measurement

Step 1: Identify the contract with the service recipient

Step 2: Identify the performance obligations in the contract

Step 3: Determine the transaction price

Step 4: Allocate the transaction price

Step 5: Recognise revenue when (or as) a performance obligation is satisfied

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New Disclosures in IFRS 15

- **Aim:** enables users of its financial statements to understand nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with service recipients
- Quantitative and qualitative
- Material transactions and balances
- Significant judgements
- Materiality – not major source of income but may still be of interest to stakeholders

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Potential IFRS 15 Impact for Local Authorities?

Areas to Consider:

- Preparing group accounts
- Complex contracts
- Significant financing component
- Variable consideration
- Discounts and their allocation
- Materiality!

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IFRS 15 - Transitional Requirements

- Cumulative approach to retrospective restatement
  - Recalculate as if always applied
  - Don’t adjust comparatives
  - Adjust reserves in Movement in Reserves Statement

- Transition disclosures required
  - Materiality
  - See Code Guidance Notes

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Other Code Changes 2018/19

- CIES – Telling the Story Amendment
  - CIES no longer provides IFRS 8 Operating Segments requirements - therefore Code no longer permits transactions between segments
  - Expenditure and Funding Analysis will now provide the main segmental analysis for IFRS 8
  - Flexibility to adjust for any differences in the EFA
- Removed disclosures on analysis of debtors and creditors across specified groupings of public sector organisations as no longer included in FReM

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IFRS 16 – Leases – Headlines (1)

- Code application date 1 April 2020 (2020/21 Code)
- Definition of a lease similar IAS 17 and IFRIC 4
- No substantial changes for lessors (except for sub-leases / sale and lease back arrangements)
- Significant changes for lessees
- More extensive disclosure requirements

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IFRS 16 – Leases – Headlines (2)

- A **contract**, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration
- Lessees – no longer classifying into finance/operating leases
- All leases on balance sheet – except for:
  - Short-term leases
  - Leases of low value assets
- Lessee recognises **right-of-use asset** and **lease liability** on balance sheet and depreciation of leased assets and interest on lease liabilities through CIES (similar to existing finance lease accounting)

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Key Code Consultation Areas (1)

- Short-term lease exemption
- Low value underlying asset exemption
- Identification of the lease
- Initial recognition of right-of-use asset and liability
- Interest rate determination
- Subsequent measurement of right-of-use asset
- Subsequent measurement of lease liability

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Key Code Consultation Areas (2)

- Concessionary leases as lessee
- Lessor accounting including sub-leases
- Sale and leaseback arrangements
- Measurement of service concession (PFI) liabilities
- Transitional arrangements
- Effective date - CIPFA/LASAAC statement:
  https://www.cipfa.org/policy-and-guidance/technical-panels-and-boards/cipfa-lasaac-local-authority-code-board

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Proposed Transition – IFRS 16

- Cumulative catch-up approach mandated
- Operating leases:
  - Lease liability = present value of payments due
  - Right of use (RoU) asset = lease liability
- Finance leases – existing carrying value
- Grandfathering arrangements to be mandated:
  - apply IFRS 16 to contracts previously identified as leases applying IAS 17 and IFRIC 4
  - don't apply IFRS 16 to contracts not previously identified as containing a lease under IAS 17 and IFRIC 4
- Various practical expedients will apply

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Practical Issues for Local Authorities (1)

- Judgements needed in key areas (exemptions, lease term, discount rate, existence of a lease, disclosures, etc.)
- Need to understand the standard and the lease when making judgements – collaborative approach required
- Disclosures - So users of financial statements can assess the effect that leases have on financial position, financial performance and cash flows of lessee and lessor
- **Evidencing completeness – are you aware of all leases to be considered?**
- CIPFA Leasing Briefings https://www.cipfa.org/policy-and-guidance/technical-panels-and-boards/cipfa-lasaac-local-authority-code-board/local-authority-leasing-briefings

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Practical Issues for Local Authorities (2)

- Elements of the asset and liability may change during the lease term…as could the lease term
- Are systems able to hold information required?
- Impact across the authority (what about schools?)
- Significant change to financial statements and accounting policies
- Group accounting impact?
- Early discussion with auditors (accounting treatment paper, grandfathering, evidence, etc.)
- Workload / project planning and resource impact

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Capital Strategy – Prudential Code Expectations

- Full Council to approve annual capital strategy
- Capital Strategy to form part of authority's integrated revenue, capital and balance sheet planning
- Strategy should set out long term context in which capital expenditure and investment decisions are made
- Needs to include sufficient detail
- Due consideration to be given to risk and reward and impact on the achievement of priority outcomes
- Links made where appropriate to Treasury Management Strategy
- CFO to report explicitly on deliverability , affordability and risk associated with capital strategy

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Capital Strategy – Key Areas

- Capital expenditure:
  - Governance
  - Long term plans
  - Asset management planning
  - Restrictions around funds
- Investments and liabilities (risks):
  - Approach, due diligence, risk appetite
  - Governance process for approval and monitoring
  - Summary of material investments, guarantees and liabilities
- Treasury Management:
  - Governance
  - Long term planning, including MRP
  - Risk appetite, key risks and sensitivities
- Skills and knowledge

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Capital Strategy – Capital Expenditure

- Overview of governance process for approval and monitoring of capital expenditure, including policies on capitalisation
- Long-term view of **capital expenditure plans** (long-term is linked to financing strategy and risks faced with reference to life of projects/assets)
- Overview of **asset management planning** including cost of past borrowing, maintenance requirements and planned disposals
- Restrictions around borrowing or funding eg requirements around HRA or Police Fund

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Asset Management Considerations

- Investment in assets requires a long-term view to be taken of future asset requirements, investment needs and ongoing capital and revenue consequences
- Investment in new / enhanced assets should be balanced against need to maintain service potential and economic benefits of existing assets
- Capital forecast should include ongoing cost of financing and maintaining existing assets including maintenance backlogs
- Capital strategy should be clear on basis of estimates

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Service Planning / Strategic Asset Management

- Service Plans should cover needs for **existing** and **new** assets required to support service delivery
- They should specify an **outline of need** and **suitability of assets** following a robust appraisal
- Asset management is a strategic activity – it does **not just** involve 'property' people – and needs to support delivery of strategic goals or objectives through the use of property assets
- It is setting a vision of where you want to be, and mapping out the journey to that place – identifying where value can be added and where investment is needed to achieve objectives

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Capital Strategy and the Asset Challenge

- Do you have an active asset challenge process whereby you know why you hold every asset?
- Do assets have an alternative use?
- Are asset valuations just for the accounts?
- What about surplus assets – why are they held and what do they cost?

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Asset Questions to Take-Away (1)

- Do you have up to date condition information on your operational assets?
- Have you created a timeline of what capital works are required and when (including component replacements)?
- Have you established building condition standards across different asset types and is your backlog maintenance figure set against those condition standards?
- Have you monitored the impact of cuts in maintenance budgets on asset condition (an asset truth)?
- Do you know what properties you have leased in and what contractual repairing obligations you are under with those leases (dilapidation costs)?

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Asset Questions to Take-Away (2)

- Are you planning to acquire new commercial property investments – If so, how much and when, and have you assessed market risks of those investments?
- Are there legislative changes that might impact on your ability to lease out commercial assets (eg Energy Act)?
- Do you have FV measurements for operational assets and are there opportunities to exploit latent value?
- Are you working actively to share property assets and could this have potential to release capital?
- What asset disposals are in the pipeline and do you know when these receipts are likely to take place?
- Are lifecycle costs taken into account?

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Other Linked Support and Training

- Streamlining the accounts guidance
- https://www.cipfa.org/policy-and-guidance/technical-panels-and-boards/local-authority-accounting-panel
- CIPFA *Introduction to*…workshops
  www.cipfa.org/essentials
- FAN membership
- https://www.cipfa.org/services/networks/finance-advisory-network

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