CIPFA/LASAAC Clarification Statement on the Provisions in the Local Authority Accounting Code on Contracts with Lender Option Borrower Option Clauses

The CIPFA/LASAAC Local Authority Accounting Code Board (CIPFA/LASAAC) received a letter from a group of auditors on 4 April 2018 requesting clarification on a number of issues relating to contracts with Lender Option Borrower Option (LOBO) clauses. CIPFA/LASAAC understands that issues were initially raised following a local government elector objection. CIPFA/LASAAC has been asked:

- whether the current Code provisions are sufficiently clear to enable local authorities to understand the appropriate accounting treatment for the various types of LOBO clauses
- where different accounting opinions could be reached, whether to require consistent accounting treatments for similar instruments, and
- whether to specify the accounting treatment in those circumstances where alternatives are available.

CIPFA/LASAAC made changes to both the 2017/18 and 2018/19 Codes following its summer 2016 consultation on the adoption of IFRS 9 *Financial Instruments.*

In response to the consultation question in relation to the approach to adaptations in the Code on financial instruments two respondents raised the issue of the adaptation in relation to LOBOs.

The 2016/17 text of paragraph 7.1.1.2 e) stated:

"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)…"*

Paragraph 7.1.6.9 [extract] stated:

> *"…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".*

A respondent commented that it was "*confused by the adaptation relating to LOBOs which states that the authority shall not separately account for the derivatives embedded in a LOBO, whilst allowing authorities the option to do just that if they feel that the terms of the loan justify it*".

CIPFA/LASAAC confirms that this was an interpretation of IFRS which sets out how a local authority is required to apply the provisions in a standard and not an adaptation which amends the standard to reflect local authority circumstances.

Paragraph 7.1.1.2[1] e) of the 2017/18 Code and paragraph 7.1.1.3 c) of the 2018/19 Code have been amended to state that options embedded in a LOBO shall not be accounted for separately and the sentence referred to above in paragraph 7.1.6.9 has been removed. The amendments to the Code also clarify which of the items listed in the paragraph(s)[2] are adaptations and which are interpretations.

The first reference to 'options' was related specifically to the call options that characterise clauses within a LOBO contract. CIPFA/LASAAC confirms that the 2018/19 Code and the 2017/18 Code continue to require that local authorities follow the provisions of IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement* respectively in relation to the accounting treatment of embedded derivatives in contracts where there are LOBO clauses.

CIPFA/LASAAC is of the view that the Code's provisions in relation to contracts with LOBO clauses do not require further adaptation or interpretation. There are a variety of complex transactions under these types of loan arrangements. However, CIPFA/LASAAC is content that the underlying financial reporting standards adopted by the Code (ie IAS 39 in the 2017/18 Code and IFRS 9 in the 2018/19 Code) provide the relevant accounting provisions and are able to reflect local government circumstances.

In the application of IFRS to complex financial instruments local authorities need to consult the application guidance in the standards as well as the provisions in the Code and the standard itself. This will require judgement based on the individual details of the contractual arrangements and may require appropriate expert advice. CIPFA/LASAAC would also comment that early discussions with external auditors are likely to be necessary.

Contracts where LOBO clauses are one of a number of special features within the contractual arrangements that may require detailed consideration of whether there are embedded derivatives (and whether that derivative is separable from the host contract). There may also be issues relating to measurement (and/or remeasurement).

The application guidance in relation to embedded derivatives is provided in paragraphs AG27 to AG33B of IAS 39, though paragraph 7.1.6.8 of the 2017/18 Code also requires that section C of IAS 39 is considered when authorities are determining whether an embedded derivative is accounted for separately.

Application guidance in relation to the use of the effective interest rate is provided in paragraphs AG5 to AG8 of IAS 39.

CIPFA/LASAAC 15 May 2018

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[1] Note that the reference to IFRS 9 in the 2017/18 Code should be read as IAS 39, consistent with the adoption of IAS 39 in the 2017/18 Code.

[2] Paragraphs 7.1.1.3 in the 2018/19 Code and 7.1.1.2 in the 2017/18 Code.