LASAAC

IFRS 9 FINANCIAL INSTRUMENTS – Earmarking of gains not available to fund services

MANDATORY GUIDANCE FOR SCOTTISH LOCAL AUTHORITIES FROM 2018/19

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Further information about LASAAC can be obtained at:
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The Chartered Institute of Public Finance and Accountancy (CIPFA) provide secretariat support for LASAAC. If you would like to contact LASAAC please communicate with

Contact: Gareth Davies
Policy & Technical Manager
CIPFA
160 Dundee Street
Edinburgh
EH11 1DQ
lasaac@cipfa.org

Background

1. IFRS 9 *Financial Instruments* has been adopted by the Code of Practice on Local Authority Accounting in the UK (the Accounting Code) from 2018/19. A key change relates to how financial assets are classified. There are three classifications, two of which require the assets to be measured at fair value. The three classifications and the treatment of movements in fair value are summarised in the following table:

Classification	Recognition of movements in fair value in Comprehensive Income and Expenditure Statement	Recognition of movements in fair value in reserves
Amortised cost	N/A	N/A
Fair value through other comprehensive income	Recognised in Other Comprehensive Income and Expenditure	Recognised in the Financial Instrument Revaluation Reserve (until derecognition)
Fair value through profit and loss	Recognised in the Surplus or Deficit on the Provision of services	Recognised in the General Fund

2. The General Fund is a usable reserve available to fund the delivery of local authority services. It is prudent that net cumulative losses arising from a decrease in fair value reduce General Fund balances. The recognition of movements in fair value in reserves raises a question regarding the extent to which net cumulative **gains** arising from increases in the fair value of a financial assets (e.g. investments) are available to fund services.

Purpose and Status of this Paper

3. This guidance represents proper accounting practices under section 12 of The Local Government in Scotland Act 2003. It applies from 1 April 2018. The purpose of the guidance is to:

    - require an element of the General Fund balance (gains arising from the measurement of financial assets at fair value) to be earmarked to the extent that it is not available to fund the delivery of services
    - set out how the above element is to be calculated
    - explain how the earmarking should be disclosed in the financial statements.

4. Where other unrealised gains are recognised in accordance with IFRS 9 (e.g. in respect of recalculating the carrying amount of modified loans), the guidance also applies to financial liabilities.

Calculating the amount to be earmarked

5. Gains arising from financial assets measured at fair value are available to fund the delivery of services to the extent they are readily convertible to cash, provided it is considered prudent to do so. This approach is consistent with the treatment of realised gains and distributable profits in the commercial sector, as explained in more detail in Appendix 1.

6. A local authority should consider gains in the fair value of a financial asset to be 'readily convertible to cash' if all of the following criteria apply:

    (a) A value can be determined at which a transaction in the asset could occur, at the date of determination, in its state at that date, without negotiation and/or marketing, to convert the change in fair value into cash.

(b) In determining the value, information such as prices, rates or other factors that market participants would consider in setting a price is observable.
(c) The authority's circumstances must not prevent immediate conversion to cash of the change in fair value; for example, the authority must be able to dispose of the change in fair value without any intention or need to liquidate or curtail materially the scale of its operations, or to undertake a transaction on adverse terms.

7. The definition of 'readily convertible to cash' is closely but not completely aligned with the definition of Level 1 and Level 2 within the fair value hierarchy in IFRS 13 *Fair Value Measurement* as adopted by the Accounting Code. In particular, point (c) above imposes some additional restrictions so that not all Level 1 and Level 2 valuations will result in realised profits. Level 3 valuations will never meet the 'readily convertible to cash' test because they are based on unobservable inputs.

8. The measurement of a financial asset may be volatile notwithstanding that fair value is properly determined in accordance with IFRS 13. Even where an increase in fair value is considered readily convertible to cash, authorities should judge whether it is prudent to use the increase to fund services where the fair value of the asset is considered to be volatile.

9. The element of the General Fund that requires to be earmarked as not being available to fund services is the net cumulative overall gain arising from the measurement of financial assets at fair value which are not readily convertible to cash. This is the minimum amount that is required to be earmarked as not available to fund services. To this value should be added any net cumulative overall unrealised gain from financial instruments that are readily convertible to cash, but the authority does not consider it prudent to use to fund services. A net cumulative overall loss for the instruments[1] must be recognised as a reduction in the resources that are available to fund services. Appendix 3 provides an illustration of application of the requirements,

Disclosure requirements

10. This guidance requires a disclosure to be made in the Annual Accounts, identifying the amount of General Fund balance at each year end that an authority considers should not be available to fund services. The disclosure will be in the form of earmarking an amount in the General Fund and providing a narrative explanation of the earmarking.

11. In accordance with LASAAC guidance on reserves, the General Fund should be a single figure on the face of the Balance Sheet. Similarly, in accordance with LAAP bulletin 99 on reserves, earmarked portions of the General Fund should not be shown separately on the face of the Movement in Reserves Statement. Authorities are therefore not permitted to disclose an analysis of the earmarked elements of the General Fund on the face of either the Balance Sheet or the Movement in Reserves Statement.

12. The Accounting Code (at paragraph 3.4.2.59 of the 2018/19 edition) requires an analysis of earmarked reserves to be disclosed in a note. LASAAC considers that this requirement applies to earmarked elements of the General Fund in Scotland. This guidance requires disclosure in this note of the earmarked amount not available to fund services accompanied by a clear narrative explanation. An illustrative disclosure is provided at Appendix 2.

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[11] For explicit clarity the 'net cumulative overall loss for the instruments' is, for instruments classified as 'fair value through profit or loss', the overall combined net unrealised loss of:

- those financial instruments which are not readily convertible to cash
  and
- those financial instruments that are readily convertible to cash, but the authority does not consider it prudent to use to fund services.

As noted Appendix 3 provides an illustration of application.

13. Where a local authority has a Housing Revenue Account (HRA), the disclosure should separately disclose the earmarked amounts for both the General Fund and the HRA. The apportionment between the General Fund and HRA should be on a basis that is fair and reasonable.

14. The narrative disclosure will need to take into consideration the fair value gains and losses held in the Financial Instruments Revaluation Reserve (FIRR). In particular, where there is a debit balance on that reserve, this should be explained in making the disclosure for the General Fund / HRA.

15. In accordance with the Accounting Code, a local authority need not disclose the earmarked amount if it is not considered material.

Appendix 1 Treatment of realised gains in commercial sector

For companies, it is only net realised profits that are available for distribution (accumulated, realised profits less its accumulated, realised losses). The Companies Act 2006 sets out what undistributable reserves are. This includes the amount by which accumulated, unrealised profits exceed its accumulated, unrealised losses. This can never be negative. This means that, in calculating the amount available for distribution, a company must reduce the amount of its net realised profits available for distribution by the amount of its net unrealised losses.

The ICAEW and ICAS jointly issued technical release *Guidance on realised and distributable profits under the Companies Act 2006* (Technical Release 02/17BL). (ISBN 978-178363-932-8). The purpose of Technical Release 02/17BL is to identify, interpret and apply the principles relating to the determination of realised profits and losses for the purpose of making distributions under the Companies Act 2006.

Technical Release 02/17BL advises there is no legal requirement for a company to distinguish in its accounts between distributable and non-distributable profits but that it may be thought helpful to users of financial statements if there is an indication of which reserves were distributable.

Technical Release 02/17BL advises that realised profits includes profits and losses resulting from the recognition of changes in fair values, in accordance with relevant accounting standards, to the extent that they are readily convertible to cash. Section 4 deals with fair value accounting, and specifically financial instruments. It provides guidance on the application of 'readily convertible to cash'. It explains that this is closely, but not completely, aligned with the definition of Level 1 and Level 2 within the fair value hierarchy in IFRS 13 Fair Value Measurement. Technical Release 02/17BL imposes some additional restrictions so that not all Level 1 and Level 2 valuations will result in realised profits. Level 3 valuations will never meet the 'readily converted to cash' test (paragraphs 3.12 and paragraph 4.2).

Losses arising from fair value accounting should be treated as realised losses where profits on remeasurement of the same asset or liability would be treated as realised profits (paragraph 4.29).

Technical Release 02/17BL considers the duties of Directors in the context of fair value accounting and volatility. Recognising that the fair value of financial instruments may be volatile, Directors should consider whether it is prudent to distribute profits arising from changes in the fair values of financial instruments even though they may otherwise be realised profits in accordance with the Technical Release 02/17BL (paragraph 2.4).

Further, the Companies Act 2006, requires a company to reduce its accumulated realised profits by the amount of its accumulated net unrealised losses (undistributable reserves).

Appendix 2 Illustrative disclosure

EARMARKED ELEMENTS OF GENERAL FUND

This note sets out the amounts earmarked in the General Fund for specific purposes and the movement in those earmarked amounts during the financial year.

The General Fund is made up of accumulated surpluses over a number of years, which are reduced when used to fund expenditure that exceeds income for the year, or to reduce Council Tax. Earmarked elements of the General Fund identify future expenditure commitments made for specific projects or services.

In addition, the General Fund is also earmarked to identify an element of the balance that is not available to fund the delivery of services. This element represents the difference between the fair value of investments at 31 March 20xx compared with their original cost. This net gain (increases less decreases) is 'unrealised' because the underlying investments have not been sold as at 31 March. The amount of the unrealised gain that is earmarked are those gains that are not readily converted to cash, plus those unrealised gains that are readily converted to cash but the authority does not consider it prudent to use to fund services. [Add reference to any debit balance on the financial instruments revaluation reserve (identifying FVOCI only)]

[Add reference to other unrealised gains recognised in accordance with IFRS 9 (e.g. in respect of recalculating the carrying amount of modified loans i.e. financial liabilities.]

The earmarked elements of the General Fund are as follows:

Earmarking	**Balance at 1 April 201x**	**Movement in year**	**Balance at 31 March 201x**
Earmarking 1			
Earmarking 2 etc			
Unrealised investment gains			
Unallocated			
TOTAL			

Appendix 3 Illustrative example of determination of treatment

Overview

The council has determined for the gains or losses on the financial instruments A - E below that these:

- do not meet the criteria to be regarded as being 'readily convertible to cash' and / or
- the financial instrument is volatile, such that it is not prudent to rely on cumulative gains in determining funding for services

Consequently the amount for the financial instruments that requires to be separately earmarked as not available for services is determined based on the following information. Note that these tables are provided to demonstrate the determination of treatment and are not specifically required in the disclosure (see Appendix 2).

Table: Summary Net Unrealised Cumulative Gains and Losses per Instrument

Notes

1. *The table represents a number of different scenarios for a mix of five different financial instruments.*
2. *For illustration purposes these are presented as a time series (eg potential cumulative gains/losses at the end of future financial years). For the purposes of the illustration it is assumed that the assessment regarding 'readily convertible to cash' or 'volatile' has not changed for any of the financial years included below.*

	General Movements as an Example	**01/04/18**	**18/19**	**19/20**	**20/21**	**21/22**	**22/23**
		£0.000m	£0.000m	£0.000m	£0.000m	£0.000m	£0.000m
A	Variable performance across 5 years	0.200	0.700	0.450	0.500	0.550	0.300
B	Variable performance across 5 years	0.200	(0.300)	(0.100)	(0.200)	0.200	0.400
C	Continued growth in FV across period	0.200	0.300	0.400	0.600	0.650	0.700
D	Continued decline in FV across period	0.200	0.100	0.000	(0.100)	(0.200)	(0.300)
E	Large Unrealised Loss Year 3	0.200	0.200	0.200	(1.200)	0.200	0.200
	Total Net Unrealised Gains and Losses	**1.000**	**1.000**	**0.950**	**(0.400)**	**1.400**	**1.300**

Table:
Impact on General Fund: Earmarked Balance and amount available for services

	01/04/18	**18/19**	**19/20**	**20/21**	**21/22**	**22/23**
	£0.000m	£0.000m	£0.000m	£0.000m	£0.000m	£0.000m
Net Amount of Unrealised Gains to be Earmarked	**1.000**	**1.000**	**0.950**		**1.400**	**1.300**
Net Amount of Unrealised Losses: Deducted from General Fund balance available to support services				**(0.400)**		