

# LAAP BULLETIN 78

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## IMPAIRMENT OF FINANCIAL ASSETS AND AMENDMENTS TO ACCOUNTING STANDARDS (FRS 26 & FRS 29)

AT THE HEART OF  
PUBLIC SERVICES 

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## BACKGROUND

1. Local authorities have the power to invest under section 12 of the Local Government Act 2003 (England and Wales), Trustee Investments Act 1961 and section 69 of the Local Government (Scotland) Act 1973 and section 56 of the Local Government Act (Northern Ireland) 1972 (as amended). When making investments, authorities are required to follow CIPFA's Treasury Management in the Public Services: Code of Practice and Cross-sectoral Guidance Notes. Local authorities may properly invest in a range of financial institutions, and for varying periods.
2. In October 2008, a number of local authorities had investments in various Icelandic banks with a range of payment due dates. In the week beginning 6 October 2008, a number of Icelandic banks went into administration. This provided objective evidence that an impairment event had occurred.
3. The difficulties experienced by the Icelandic banks are a symptom of the problems experienced in the global financial markets during the latter half of 2008. The difficulties are highly unusual, and have prompted both the International Accounting Standards Board and the Accounting Standards Board to issue amendments to financial reporting standards (see paragraphs 52 – 61 of this bulletin for more details).
4. This bulletin provides details of the processes that authorities should follow in deciding whether an investment has been impaired and, if so, how to measure the impairment. Impairment is a two stage process. The first stage is to identify an impairment event (such as a bank going into administration). The second stage involves determining whether there has been an impairment loss by comparing the estimated recoverable amount to the carrying value of the loan.
5. This bulletin has been written in the context of the possible investment losses in Icelandic banks arising from problems in the global financial markets in the latter half of 2008. However the principles included in the bulletin are applicable to any similar investment loss. Examples in the bulletin are for illustrative purposes only, and do not represent CIPFA's view of the proportion of an investment that is likely to be recoverable from the Icelandic banks that went into liquidation in 2008 or any future event.

## ACCOUNTING REQUIREMENTS

### *Loans and Receivables carried at Amortised Cost*

6. The investments made in the Icelandic banks were money market deposits, and are therefore likely to be classified as loans and receivables for accounting purposes. Loans and receivables are carried in the balance sheet at amortised cost. Paragraph 4.67 of the 2008 SORP states that:

*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 should be reduced to its recoverable amount either directly or through the use of an allowance account. The amount of the loss is included in the Income and Expenditure Account.*

7. Paragraph 4.62 of the 2008 SORP gives examples of events that provide the objective evidence of impairment required by paragraph 4.67:

*(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).*
8. Example (a) *significant financial difficulty of the creditor* clearly applies in the case of the Icelandic banks. Where an authority was due to receive a repayment and/or a payment of interest but has not done so, example (b) *a breach of contract, such as a default or delinquency in interest or principal payments* will also apply; this breach of contract will also provide further evidence for those authorities whose investments have yet to mature of the financial difficulties of the creditor. Finally, some of the banks have entered administration, providing evidence that example (d) *it becoming probable that the borrower will enter bankruptcy or other financial reorganisation* applies.
9. The analysis clearly indicates that an impairment event has occurred. An impairment will occur where the carrying amount of the asset exceeds the recoverable amount. Authorities will therefore need to estimate the recoverable amount of the investment in order to determine if an impairment has in fact occurred. This bulletin provides advice on the methods that can be used in making such an estimate, and on the appropriate time to make such an estimate.
10. When considering whether other investments also need to be impaired, authorities should note that paragraph 4.62 of the SORP states that "*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, should not be recognised.*"

#### *Available for Sale Financial Assets*

11. Whilst investments with the Icelandic banks will normally be classified as loans and receivables, it is possible other financial assets that are classified as available for sale will become impaired. The criteria for assessing when impairment may have taken place are the same as for assets classified as loans and receivables, and are set out in paragraph 4.62 of the SORP (see paragraph 7 of this bulletin). A movement in market value resulting in the asset having a lower fair value is not evidence of impairment.
12. Where an available for sale financial asset has been impaired, an authority will need to charge the Income and Expenditure Account with the impairment. This includes any

previous losses on the asset that have been recognised in the Available-for-Sale Reserve, in accordance with paragraph 4.68 of the SORP:

*If there is objective evidence of impairment of an available-for-sale financial asset, the cumulative net loss that has previously been recognised in the STRGL is removed from the Available-for-Sale Reserve and recognised in the Income and Expenditure Account, 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 the Income and Expenditure Account.*

#### *Assets held as at Fair Value through Profit or Loss*

13. There is a possibility that an authority may have an investment that is held as at fair value through profit or loss. This could arise where an authority has engaged a fund manager to manage a portfolio of assets, and part of the portfolio has been traded (i.e. there is evidence of a recent actual pattern of short-term profit taking). In such circumstances, the whole of the portfolio would be classified as at fair value through profit or loss. Such a portfolio may include cash deposits in banks, including Icelandic banks.
14. No additional accounting treatment is required for the impairment of assets held as at fair value through profit or loss, as any movement in the fair value of the asset is recognised in the Income and Expenditure Account. Any impairment of an asset held as at fair value through profit or loss would automatically be reflected in the fair value of the asset.

#### *Impact on 2007/08 Accounts*

15. A small number of authorities had not adopted their accounts or the audit opinion had not been given at the point when the Icelandic banks were unable to make repayments. The problems experienced by these banks therefore constituted an event after the balance sheet date that would need to be reflected in the Statement of Accounts. Events after the balance sheet date can be adjusting events (requiring amendments to the core statements where the event provides evidence of conditions that existed at the balance sheet date) or non-adjusting events (requiring a narrative disclosure where the event provides evidence of conditions that arose after the balance sheet date).
16. CIPFA has concluded that the problems experienced by the banks arose from difficulties in the global financial markets in summer 2008 (i.e. after the balance sheet date) and are therefore a non-adjusting event. Authorities with investments in Icelandic banks that have yet to close their accounts will therefore need to make a narrative disclosure in their accounts.
17. A consequence of this analysis is that any authority who had an investment with an Icelandic bank at 31 March 2008 that is at risk of loss will not need to restate their 2007/08 accounts in their 2008/09 accounts to recognise the impairment. Instead, the impairment will be recognised as occurring in 2008/09.

#### *Impact on 2008/09 Accounts*

18. The event provides objective evidence that an impairment event has occurred in 2008/09, but does not in itself provide evidence that the carrying value of a loan exceeds its estimated recoverable amount. Where there is evidence that the carrying value of a loan exceeds its estimated recoverable amount, the impairment will almost certainly need to be recognised in the Income and Expenditure Account in 2008/09. The only exception would be if no information was available on which to assess whether or not an impairment had in fact occurred. In such circumstances it would be necessary to close the 2008/09 accounts without recognising the impairment; instead the notes to the

accounts would need to disclose a fundamental uncertainty as to whether or not an impairment had occurred. As the accounts would need to be adjusted for any information received prior to the accounts being signed off (around September 2009) this is not expected to occur.

19. Where information is available to allow the authority to assess the impairment, even where this information is imperfect, the authority will be required to make an assessment of the impairment, and recognise this in the Income and Expenditure Account in 2008/09.
20. Paragraph 4.67 of the SORP (see paragraph 6 of this bulletin) states that the carrying amount of a loan of a financial asset carried at amortised cost should be reduced to its recoverable amount, either directly or through the use of an allowance account. The recoverable amount is defined as "the present value of the expected future cash flows discounted at the instrument's original effective interest rate".
21. Available for sale financial assets are carried at fair value, and an authority which held assets in this category that had been impaired would need to estimate the fair value of the asset as at the balance sheet date. Assets held as at fair value though profit or loss are not subject to impairment since all movements in fair value are recognised in the Income and Expenditure Account.
22. Identifying or estimating the recoverable amount or fair value is the key task in assessing an impairment of an investment and the techniques that can be used are discussed below.

*Techniques used in assessing the Recoverable Amount of a Financial Asset carried at Amortised Cost*

23. The recoverable amount would be clearly identifiable where the bank (or the bank's administrator) had announced how much would be repaid and over what timescales. The recoverable amount would be the expected future cash flows, discounted at the original effective interest rate. The calculations are shown in the example below:

**Example 1**

An authority invested £10 million in ABC Bank for six months at 5.5%, repayable on 31 March 2009. At the balance sheet date (31 March 2009), the carrying amount of the investment was £10,275,000 (the interest receivable of £275,000 being recognised in the Income and Expenditure Account). The bank has experienced financial difficulties, and as a result the repayment of the investment has not been made. The administrator has announced (prior to the 2008/09 accounts being closed) that 45% of the principal will be repaid on 31 March 2010 and 45% on 31 March 2011. No interest will be paid. The recoverable amount can therefore be calculated as follows:

Date	Discount Factor	Repayment	Present Value
31 March 2010	0.94787	£4,500,000	£4,265,415
31 March 2011	0.89845	£4,500,000	£4,043,025
TOTAL			£8,308,440

The recoverable amount of the investment is £8,308,440, which is £1,966,560 less than the carrying amount of the investment. An impairment of £1,966,560 would therefore need to be recognised in the Income and Expenditure Account in 2008/09.

The accounting entries that will be required in 2008/09 are:

Dr	Income & Expenditure Account (impairment)	£1,966,560
Cr	Financial Assets (or the Allowance Account if one is being used) (impairment)	£1,966,560
Dr	Financial Assets (interest receivable credited to I&E)	£275,000
Cr	Income & Expenditure Account (interest receivable credited to I&E)	£275,000

The amortised cost method requires that interest continue to be credited to the Income and Expenditure Account until the financial instrument has been derecognised. This will be the point at which the final payment in respect of the investment is received. As final payment will not be received until 31 March 2011, interest will be credited to the Income and Expenditure Account in both 2009/10 and 2010/11.

Interest credited to the Income and Expenditure Account in 2009/10 will be £456,964 (the carrying amount at 31 March 2009 of £8,308,440 multiplied by the interest rate of 5.5%, applicable for 1 year). The carrying amount of the investment at 31 March 2010 will be £4,265,404 (opening carrying amount of £8,308,440 plus interest of £456,964 credited to the Income and Expenditure Account less the first payment of £4,500,000 to be received from the administrator on 31 March 2010). The accounting entries in 2009/10 will be:

Dr	Financial Assets (interest credited to I&E)	£456,964
Cr	Income & Expenditure Account (interest credited to I&E)	£456,964
Dr	Cash (payment received)	£4,500,000
Cr	Financial Assets (payment received)	£4,500,000

Interest credited to the Income and Expenditure Account in 2010/11 will be £234,596 (the carrying amount at 31 March 2010 of £4,265,404 multiplied by the interest rate of 5.5%, applicable for 1 year). The carrying amount of the investment at 31 March 2011 will be £ nil (opening carrying amount of £4,265,404 plus interest of £234,596 credited to the Income and Expenditure Account, less the final payment of £4,500,000 to be received from the administrator on 31 March 2011). The accounting entries in 2010/11 will be:

Dr	Financial Assets (interest credited to I&E)	£234,596
Cr	Income & Expenditure Account (interest credited to I&E)	£234,596
Dr	Cash (payment received)	£4,500,000
Cr	Financial Assets (payment received)	£4,500,000

Over the three years, the net amount charged to the Income and Expenditure Account is £1,000,000. This represents the loss of the principal amount, and also recognises no interest will be receivable.

Authorities should note that where interest is expected to be receivable from the administrator, this should be included in the net present value calculations.

Further examples, covering different scenarios, are given in Appendix A to this bulletin.

24. It is more likely that definitive information will not be available, and that the authority will need to estimate the recoverable amount. For example, the bank (or the bank's administrator) may not quote an amount that will be repayable, but may instead quote a range (e.g. 50% - 80% of the principal). In such circumstances, the authority will need to use its judgement to estimate the most likely amount that would be repaid. Impairment should be based on an authority's best estimate of the amount that would be repaid, not on the worst case scenario. If a range of 50% - 80% were quoted, the authority might determine that each possible repayment amount between 50% and 80% had an equal chance of occurring; its best estimate of the amount to be repaid would therefore be 65% (the average of 50% and 80%). A different estimate of the probabilities would lead to a different estimate of the recoverable amount. An example is given below:

### Example 2

An authority invested £10 million in ABC Bank for six months at 5.5%, repayable on 31 March 2009. At the balance sheet date (31 March 2009), the carrying amount of the investment was £10,275,000 (the interest receivable of £275,000 being recognised in the Income and Expenditure Account). The bank has experienced financial difficulties, and as a result the repayment of the investment has not been made. The administrator has announced (prior to the 2008/09 accounts being closed) that 45% of the principal will be repaid on 31 March 2010 and between 35% and 45% of the principal on 31 March 2011. No interest will be paid. Based on other pronouncements made by the administrator, the authority assesses the probabilities of the likely repayment on 31 March 2011 as follows:

35% repayment – 50% probability  
 40% repayment – 30% probability  
 45% repayment – 20% probability

The recoverable amount can therefore be calculated as follows, using the present value calculations:

Date	Option 1 – 35% repayment on 31 March 2011	Option 2 – 40% repayment on 31 March 2011	Option 3 – 45% repayment on 31 March 2011
31 March 2010 (45% repayment in all options)	£4,265,415	£4,265,415	£4,265,415
31 March 2011	£3,144,575	£3,593,800	£4,043,025
Total Present Value	£7,409,990	£7,859,215	£8,308,440
Probability of Option Occurring	50%	30%	20%
Present Value x Probability	£3,704,995	£2,357,765	£1,661,688

The best estimate of the recoverable amount will be the weighted average of each option – the sum of the present value of each option multiplied by the

probability of that option occurring. This gives a recoverable amount of £7,724,448 (£3,704,995 + £2,357,765 + £1,661,688). This recoverable amount is £2,550,552 less than the carrying amount of the investment. An impairment of £2,550,552 would therefore need to be recognised in the Income and Expenditure Account in 2008/09, as shown in Example 1.

Interest would be credited to the Income and Expenditure Account in 2009/10 and 2010/11, as shown in Example 1.

A further example is shown in Appendix A

25. Uncertainty may not be limited to the amounts that will be repaid, but may extend to when the payments will be made. In this case, the authority will need to estimate the likelihood of the payment being made at a particular date as well as estimating the likely amount of each payment. This will create additional options. Authorities will need to consider whether the probability of a particular amount being repaid is related to the probability of the payment being made at a particular time.
26. Where the probabilities are related, the authority will need to assess the probability of each option occurring individually. Where the probabilities are not related, the authority can assess the probability of each option occurring by multiplying the probability of the payment amount by the probability of the payment date. This is shown in the example below:

### Example 3

The administrator has announced that the final payment will be between 35% and 45% of the principal, and will be made on either 31 March 2011 or 31 March 2012. Based on other pronouncements made by the administrator (prior to the 2008/09 accounts being closed), the authority assesses the probabilities of the likely final repayment as follows; the probabilities of the repayment amount and the repayment date are not related:

35% repayment – 50% probability  
 40% repayment – 30% probability  
 45% repayment – 20% probability

2011 repayment – 70% probability  
 2012 repayment – 30% probability

The probability for each option can be calculated as follows:

	35% Repayment 50% Probability	40% Repayment 30% Probability	45% Repayment 20% Probability
2011 Repayment 70% Probability	$(50\% \times 70\%) = 35\%$	$(30\% \times 70\%) = 21\%$	$(20\% \times 70\%) = 14\%$
2012 Repayment 30% Probability	$(50\% \times 30\%) = 15\%$	$(30\% \times 30\%) = 9\%$	$(20\% \times 30\%) = 6\%$

Having assessed the probability of each option, the best estimate of the recoverable amount is assessed using the same techniques as in Example 2 above.

It is important to note, though, that this approach is not suitable for use in cases where the probability of the likely amount to be repaid and the probability of the repayment date are interconnected. Where a higher recoverable amount is

associated with a longer wait for repayment, then authorities will need to make a judgment based estimate of the probabilities of the various possible outcomes, subject to considerations of materiality.

27. An alternative method of valuing investments would be available where a secondary market arose, with third parties willing to pay for the right to any future payments from the banks. The third parties would then be exposed to the risks and rewards of the payments being lower or higher than anticipated. Using this method, the recoverable amount of the investment would be the market value as at the balance sheet date. This method should be used to estimate the recoverable amount of an asset carried at amortised cost only where the information required to estimate future cash flows is unavailable, and where there is reliable evidence that trading in the investment has actually taken place on a regular basis and in amounts commensurate with the size of the investment concerned.
28. It is possible that a secondary market will arise after the balance sheet date, but before the accounts are authorised for issue. Where information to calculate the recoverable amount by use of the discounted cash flows technique is not available, the recoverable amount of the asset should be based on the first available market price. However, as this price will reflect a value at a date later than the balance sheet date, the price should be discounted back to the balance sheet date, using the original effective interest rate.
29. Authorities will continue to credit interest to the Income and Expenditure Account until payment is received, calculated using the original effective interest rate applied to the revised carrying amount. This is because the amortised cost method recognises the loss in the impairment of the principal amount rather than removing interest earned altogether. Together with the payments received, this will reduce the carrying amount of the investment to zero when it is finally repaid (as shown in Example 1).
30. Paragraph 4.63 of the SORP requires an assessment of whether an impairment has occurred to be made at each balance sheet date. This means that investments with banks which failed in 2008/09 (such as the Icelandic banks) with a maturity date later than 31 March 2009 are also likely to require an impairment to be recognised in the 2008/09 accounts, in the same way as investments that will mature in 2008/09. Where this is the case, accrued interest should be credited to the Income and Expenditure Account, based on the amount invested, to 31 March 2009. The investment should then be impaired, and interest to be credited to the Income and Expenditure Account in future years will be based on the recoverable amount / amortised cost of the investment, as in Example 1.

*Techniques used in assessing the Fair Value of an Available for Sale Financial Asset or a Financial Asset carried as at Fair Value through Profit or Loss*

31. Paragraphs 4.52 – 4.56 of the SORP detail the hierarchy to be followed when assessing fair value. For an asset carried at fair value (i.e. available for sale or as at fair value through profit or loss), a market based valuation method should be used unless no active market exists. Where an asset has previously been traded, the market value (assuming there is still an active market) as at the balance sheet date should therefore be used.
32. Where an asset has not previously been traded (for example, where the asset is a cash deposit that was classified as at fair value through profit or loss because it was part of a portfolio – see paragraph 13 of this bulletin), or where there is no longer an active market for the asset, it is possible a secondary market will arise (see paragraph 27 of this bulletin). In such circumstances, the asset should be valued on the basis of the secondary market.

33. Where there is no active market for the financial asset, valuation techniques should be used to assess fair value. Paragraph 4.54 of the SORP provides three examples of valuation techniques that could be used:

- (i) recent market transactions;
- (ii) reference to a transaction that is substantially the same; and
- (iii) discounted cash flows and option pricing models.

The aim of the techniques is to model the fair value that the use of a market would produce.

34. Where an authority uses one of the first two techniques referred to in the SORP (recent market transactions or reference to a transaction that is substantially the same – see paragraph 33 of this bulletin), the transactions should refer to a financial asset that has been impaired in a similar manner to the asset being valued. Where the comparative transactions do not relate to an impaired asset, these methods should only be used where it is possible to adjust the transactions to take account of the impairment.

35. The discounted cash flows technique referred to in the SORP and paragraph 33 of this bulletin is similar to the technique described in paragraphs 23 - 26 of this bulletin. The difference between the two techniques is that, for financial assets carried at fair value, the discount rate to be used should be the current market rate rather than the original effective interest rate, as this will reflect the price that the market is currently willing to pay for the expected cash flows. As the aim of the valuation technique for an asset carried at fair value is to model the price that would be paid in an active market, it may be appropriate to adjust the value produced by using the discounted cash flows technique to allow for the risk premium that the market would require where there is uncertainty as to the amount and/or timing of the cash flows.

#### *Capitalisation Directions / Consents to Borrow*

36. In England, the Government has indicated that capitalisation directions will be considered on a case by case basis. For local authorities in England, advice on applying for capitalisations is given at:

<http://www.local.communities.gov.uk/finance/capital/guidance0809.pdf>

37. The Welsh Assembly Government has indicated that it will take the same line on capitalisation directions in Wales. Advice on applying for capitalisations in Wales is available on the Publications page at:

<http://new.wales.gov.uk/topics/localgovernment/?lang=en> (English)

<http://www.cymru.gov.uk/llywodraethlleol> (Welsh)

38. In Scotland, Scottish Ministers have the power to permit local authorities to borrow to fund non-capital expenditure. This 'consent to borrow' power is contained in the Schedule 3 of the Local Government (Scotland) Act 1975, and is limited to borrowing. At the time this bulletin was prepared, Scottish Ministers had not considered whether such a scheme should be made available in Scotland, but any such scheme would be based on need.

39. Where a capitalisation or consent to borrow is given, authorities should account for the direction as Revenue Expenditure funded from Capital under Statute. The amount capitalised will then be charged to the General Fund over time via the Minimum Revenue Provision (Loans Fund Charges in Scotland and Northern Ireland) unless other resources such as capital receipts have been applied to fund the impairment charge. The accounting entries will be as follows:

- Dr Capital Adjustment Account (amount of capitalisation direction / consent to borrow – to fund the impairment from capital resources)
- Cr General Fund (Statement of Movement on General Fund Balance) (amount of capitalisation direction / consent to borrow – to fund the impairment from capital resources)

Where capital receipts are used to fund the impairment, the following entries are also required.

- Dr Capital Receipts Reserve (any amount funded from capital receipts - England and Wales only)
- Cr Capital Adjustment Account (any amount funded from capital receipts - England and Wales only)

#### *Considerations for the 2009/10 Budget*

40. Impairment of investments in 2008/09 could have an impact on authorities' 2009/10 budget in two ways:

- (i) Where a capitalisation direction is given to the authority to cover an impairment charge in 2008/09, MRP or Loans Fund Charges would normally be payable from 2009/10 (unless other resources such as capital receipts are used to fund the impairment).
- (ii) Where no direction is given, authorities will have had to finance the impairment from general reserves or other revenue resources in 2008/09.

This may require authorities to replenish their reserves in 2009/10 to ensure that the level of reserves is adequate. Further guidance on assessing the level of reserves can be found in LAAP bulletin 77, published in November 2008.

41. Authorities may find the following process useful in assessing the impact of the impairment on their 2009/10 budgets.

- (i) The authority should assess the expected level of impairment, using the best available information at the time that the budget is set. This will be more difficult for assets held at fair value, as authorities will need to estimate the likely market conditions as at the balance sheet date. Where, during the preparation of the budget, information is not available or is uncertain, the authority may find it helpful to produce a range of possible impairment charges, so that different budget scenarios can be planned.
- (ii) The authority should assess whether it would meet the criteria for a capitalisation direction or consent to borrow. Reference should be made to the relevant guidance on the circumstances in which a direction may be issued to assist with this assessment.

<http://www.local.communities.gov.uk/finance/capital/guidance0809.pdf>  
<http://new.wales.gov.uk/topics/localgovernment/?lang=en> (English)  
<http://www.cymru.gov.uk/llywodraethlleol> (Welsh)

- (iii) Where an authority would not meet the criteria for a capitalisation direction or consent to borrow, the authority should plan to fund the impairment using its own revenue resources. The authority should consider whether funds will be required in 2009/10 to replenish reserves to an adequate level. An authority may previously have held reserves at a higher than an 'adequate' level. In such circumstances, the authority should consider whether this higher level is still appropriate, and if so whether it should replenish the reserves to that level immediately or over a period of time.
- (iv) Where an authority would meet the criteria for a capitalisation direction or consent to borrow, it should determine whether an application is the appropriate method of funding the impairment. Where the authority decides that this is the case, it should ensure an application is submitted as soon as is practicable. In England, the deadline for applications relating to 2008/09 is 15 December 2008, although the DCLG has indicated that later applications will be considered if exceptional. There is no specific deadline in Wales, although applications should be submitted as soon as practicable. Authorities should be aware that applications will be considered on a case by case basis. An application may therefore result in a capitalisation direction or consent to borrow not being issued, or being issued for less than the amount of the application. Consequently authorities should consider contingency planning for any possible shortfalls in funding. **[Note that since the bulletin was originally issued, the process for 2008/09 has been overtaken by the issuing of regulations – see LAAP Bulletin 79]**
- (v) Where an authority has submitted an application for a capitalisation direction or consent to borrow, and a decision has not been made at the time the budget is set, the authority will need to assess the likely level of the direction or consent, based on any pronouncements made by central government.
- (vi) Having determined the level of direction to use in preparing the budget, authorities should assess the amount of the impairment that will need to be funded from general reserves or other revenue resources in 2008/09. The use of reserves or other revenue resources in 2008/09 may require funds to be set aside in 2009/10 to replenish reserves, and these should form part of the 2009/10 budget. MRP (Loans Fund Charges in Scotland and Northern Ireland) on the capitalisation direction would normally be payable from 2009/10 (unless other resources, e.g. capital receipts, have been set aside to fund the impairment) and should also form part of the 2009/10 budget.
- (vii) It is possible that central government will issue regulations or statutory guidance relating to the accounting issues, for example in relation to MRP or Loans Fund charges. Therefore authorities should keep up to date with such matters to ensure they can take advantage of any mitigating regulations or guidance as they arise. **[Since the bulletin was originally issued, regulations and statutory guidance have been issued – see LAAP Bulletin 79]**

42. Funding the impairment of an investment may also have other consequential impacts on the 2009/10 budget. For example, the impairment is likely to lead to a loss in interest income (both due to the impairment and in future) as well as the potential loss of principal, and an authority may need to take a more cautious view of efficiency savings if reserves have been reduced and are therefore not available to cover any delay in achieving the efficiency savings. Authorities will need to take all such factors into

account in setting their 2009/10 budget. The impact of funding any impairment is likely to continue into future years, and should be taken into account in the medium term financial plan.

*Budget Monitoring (2008/09 and 2009/10)*

43. Section 28 of the Local Government Act 2003 requires a local authority in England and Wales to monitor their budget requirement during the year and to take the action it considers necessary to deal with the situation where there is deterioration in the authority's financial position. Where funding an impairment could result in a deficit on the General Fund, authorities will need to consider what action is required to comply with the legislation. This would be good practice in Scotland and Northern Ireland.

*Impact on the Housing Revenue Account (England and Wales)*

44. Legislation does not permit an impairment of an investment to be charged to the Housing Revenue Account. However, the SORP requires the HRA Income and Expenditure Account to be prepared following proper practices, with items that are not permitted by statute to be charged to the HRA being adjusted for in the Statement of Movement on the HRA Balance. Authorities should therefore initially apportion the impairment between the General Fund and HRA. The HRA portion of the impairment should then be transferred to the General Fund through the Statement of Movement on the HRA Balance. The apportionment of the impairment loss to the HRA should be based on the percentage of total investment income earned that is credited to the HRA in the HRA Income and Expenditure Account. Where authorities are crediting the HRA Income and Expenditure Account with interest calculated on the basis of the Item 8 determinations, reference should be made to paragraph 46 of this bulletin.

45. Amounts debited or credited to the HRA under the Item 8 determinations may also be affected by an impairment of an investment. Where a capitalisation is awarded, this may affect the authority's capital financing requirement at the end of the year. An impairment of an investment may also lead to an authority borrowing more than it would otherwise have done, which may result in a revised consolidated rate of interest. Both factors should be taken into account when calculating the Item 8 amounts.

46. Authorities will also need to recalculate the average rate of interest in respect of interest receivable by the authority. This rate is used to attribute interest income to the HRA Income and Expenditure Account. The wording in the Item 8 determinations has not been updated since the adoption by the SORP of the financial instruments standards.

47. Consequently, there appear to be two options for calculating this rate:

- The first is to base the rate on the interest accrued in the year and the amounts of principal invested.
- The second is to calculate the rate using the amortised cost method.

48. The DCLG and the Welsh Assembly Government are actively considering which method should be used (or whether both are acceptable), and both will consider issuing further guidance. The first method (interest accrued and principal invested) would appear to be most consistent with the Item 8 calculation. However, prior to calculating the average rate of interest, authorities should confirm their proposed method is consistent with any guidance issued by CLG or the Welsh Assembly Government. Details of how both methods are calculated are given in Appendix B of this bulletin, along with worked examples. Authorities should note that, prior to any impairment, both methods would have produced either the same result or results that were not materially different. Item 8 credits in 2007/08 would therefore not have been affected by the choice of a particular method.

*Impact on Loans Fund and Borrowing Accounts (including Housing Revenue Account) in Scotland*

49. The Housing (Scotland) Act 1987 requires credits to the Housing Revenue Account in respect of income from the investment of cash balances. The Loans Fund will provide the HRA with Interest on Revenue Balances (IORB) throughout the year. The interest credited to the HRA should be calculated in accordance with LASAAC Guidance Note No. 2.
50. The impairment of an investment will initially be a charge to the Loans Fund. The Loans Fund will then recover this charge by increasing the amount it charges (through interest and expense charges) to borrowing accounts, including the HRA. The Housing (Scotland) Act 1987 requires loan charges to be debited to the Housing Revenue Account.
51. Where a consent to borrow has been issued, a transfer between the General Fund (and/or the HRA balance) and the Capital Adjustment Account will have taken place (see paragraphs 36 – 39 of this bulletin) to increase revenue reserve balances. The provision of any such additional borrowing should be recognised by an increase in the recorded Loans Fund advance to the relevant borrowing account(s). Over time the General Fund and/or the HRA balance (i.e. the revenue reserve(s)) will be charged by the Loans Fund for the principal repayment of the borrowing. Any interest on the amount borrowed under such consent will be dealt with in the normal manner i.e. interest will be paid by the Loans Fund which will then charge borrowing accounts interest at the pool rate, based on advances outstanding for the year as specified in LASAAC Guidance Note No. 2. If these arrangements lead to a deficit on the HRA balance, a transfer from the General Fund to meet the deficit will be required (as per Housing (Scotland) Act 1987 Schedule 15 paragraph 9 (2)).

*Changes to Accounting Standards*

52. The problems experienced in the global financial markets have led the International Accounting Standards Board to issue amendments to IAS 39 and IFRS 7. Unusually, these amendments can be applied retrospectively from 1 July 2008. These international standards form the basis of converged standards in the UK, and the Accounting Standards Board has implemented the changes (again with retrospective effect from 1 July 2008) to FRS 26 and FRS 29. The amendments can be downloaded from:  
  
<http://www.frc.org.uk/images/uploaded/documents/Amend%20to%20FRS%2026%20FINANCIAL%20WEB%20OPTIMIZED.pdf>
53. Authorities may therefore take advantage of the revised provisions of the accounting standards, which are outlined in the following paragraphs.
54. The first amendment concerns financial assets that were at recognition intrinsically loans and receivables but which the entity exercised its discretion under FRS 26 to designate them as available-for-sale and therefore to carry them at fair value with changes in fair value taken to equity. The amendment permits an entity to transfer such financial assets to the loans and receivable category if it has the intention and ability to hold the financial assets for the foreseeable future.
55. This amendment would not have any effect on local authorities' current financial position since the SORP does not permit authorities to 'designate' financial instruments but requires them to be classified in accordance with their intrinsic characteristics.
56. The second amendment permits an entity that holds a financial asset classified as at fair value through profit or loss, other than if it has designated it to that class, to reclassify it out of fair value through profit or loss if the financial asset is no longer held for the purpose of selling or repurchasing it in the near term, if the following conditions are met:

(a) That the instrument would have met the definition of a loans and receivables if it had not been required to be classified as held for trading at initial recognition.

Or

(b) Financial assets other than those in (a) above can sometimes be reclassified out of fair value through profit or loss but only in "rare circumstances".

In both cases, the entity must have the intention and ability to hold the financial asset for the foreseeable future or until maturity.

57. With regard to (a) it is highly unlikely, with one exception, that any authority would have classified any financial assets as at fair value through profit or loss that would meet the definition of loans and receivables. Loans and receivables have fixed or determinable payments and are not quoted in an active market. It would be highly unusual if a local authority was 'trading' in loans and receivables rather than holding them to facilitate the discharge of its statutory functions.
58. The one exception where an authority may have classified a financial asset as at fair value through profit or loss that would have met the definition of loans and receivables is where the asset formed part of a portfolio managed by fund manager, and part of the portfolio was "held for trading". In such circumstances, an authority is permitted to reclassify the asset as a loan or receivable from 1 July 2008.
59. With regard to (b) this might apply to local authorities to a limited extent. Some authorities are likely to have classified some quoted securities as at fair value through profit or loss. Amendments to the 2008 SORP highlighted that if a portfolio of financial assets is held for trading as evidenced by active management and routinely involves selling assets before maturity to achieve higher returns an authority should consider carefully whether the portfolio should be classified as at fair value through profit or loss. Portfolios of assets designated as at fair value through profit or loss are likely to be managed by external managers who have been employed to achieve higher returns by more actively managing investments. "Rare circumstances" are not defined in the body of the standard but the basis for conclusions comments "*rare circumstances arise from a single event that is unusual and highly unlikely to occur in the near term*".
60. The recent turmoil in the financial markets is considered to be such a "rare event", and authorities may therefore reclassify financial assets such as quoted securities previously held as at fair value through profit or loss (trading) as available for sale. The reclassification can take place from 1 July 2008. The effect of the reclassification is that fair value gains and losses on these types of financial assets will be recorded in the Statement of Total Recognised Gains and Losses rather than the Income and Expenditure Account from the date the assets are reclassified, which will avoid the recent volatility impacting on Council Tax.
61. Adoption of the changes to FRS 26 and FRS 29 does not require a change to the SORP. The first amendment does not apply to local authorities, as the SORP prohibits designation, and therefore no change to the SORP would be required for this amendment. The second amendment relates to the reclassification of financial instruments currently held as at fair value through profit or loss. The SORP provisions relating to these financial instruments are contained in Annex 2 of Chapter 4 of the SORP. Paragraph 15 states that "The SORP does not include detailed requirements on accounting for financial instruments at fair value through profit or loss because they are less commonly held by local authorities. However, where such instruments are held by a local authority they should be accounted for in accordance with the appropriate financial reporting standards." As the SORP refers authorities to the financial reporting standards, no amendment to the SORP is required to effect this amendment, and authorities should refer to the amended standards.

## Worked Examples – Impairment

This Appendix provides additional examples to those shown in paragraphs 23 – 26 of the Bulletin. These examples cover more complex scenarios than those in paragraphs 23 – 26 of the Bulletin, and are provided to assist authorities with the identification of the appropriate accounting treatment in more complex situations.

## Example A

An authority invested £10 million in ABC Bank for six months at 5.5%, repayable on 31 March 2009. At the balance sheet date (31 March 2009) the carrying amount of the investment would be £10,275,000 (the interest receivable of £275,000 being recognised in the Income and Expenditure Account) prior to any payment being received. The bank has experienced financial difficulties. The administrator has announced (prior to the 2008/09 accounts being closed) that 45% of the principal will be repaid on 31 March 2010 and 45% on 31 March 2011. Interest will continue to be paid (including in 2009/10 and 2010/11), but will be based on the revised value of the investment (i.e. £9 million, 90% of the original investment). The recoverable amount can therefore be calculated as follows:

Date	Discount Factor	Repayment	Present Value
31 March 2009	1.00000	£247,500	£247,500
31 March 2010	0.94787	£4,995,000	£4,734,610
31 March 2011	0.89845	£4,747,500	£4,265,390
TOTAL			£9,247,500

The recoverable amount of the investment is £9,247,500, which is £1,027,500 less than the carrying amount of the investment. An impairment of £1,027,500 would therefore need to be recognised in the Income and Expenditure Account in 2008/09. As interest is continuing to be paid, this impairment is equal to the loss of principal of £1 million, plus the loss of interest during 2008/09 on the lost principal (£1 million multiplied by 5.5% for six months). As interest of £247,500 will be paid on 31 March 2009, the carrying amount of the investment will be £9,000,000 (recoverable amount of £9,247,500 less interest paid of £247,500).

The accounting entries required in 2008/09 are:

Dr	Income & Expenditure Account (impairment)	£1,027,500
Cr	Financial Assets (or the Allowance Account if one is being used) (impairment)	£1,027,500
Dr	Cash (interest received)	£247,500
Cr	Financial Assets (interest received)	£247,500
Dr	Financial Assets (income credited to I&E)	£275,000
Cr	Income & Expenditure Account (income credited to I&E)	£275,000

The amortised cost method requires that interest continue to be credited to the Income and Expenditure Account until the financial instrument has been

derecognised. This will be the point at which the final payment in respect of the investment is received. As final payment will not be received until 31 March 2011, interest will be credited to the Income and Expenditure Account in both 2009/10 and 2010/11.

Interest credited to the Income and Expenditure Account in 2009/10 will be £495,000 (the carrying amount at 31 March 2009 of £9,000,000 multiplied by the interest rate of 5.5%, applicable for 1 year). The carrying amount of the investment at 31 March 2010 will be £4,500,000 (opening carrying amount of £9,000,000 plus interest of £495,000 credited to the Income and Expenditure Account less the first payment of £4,995,000 to be received from the administrator on 31 March 2010, the payment comprising £4,500,000 principal and £495,000 interest). The accounting entries required in 2009/10 will be:

Dr	Financial Assets (interest credited)	£495,000
Cr	Income & Expenditure Account (interest credited)	£495,000
Dr	Cash (payment received)	£4,995,000
Cr	Financial Assets (payment received)	£4,995,000

Interest credited to the Income and Expenditure Account in 2010/11 will be £247,500 (the carrying amount at 31 March 2010 of £4,500,000 multiplied by the interest rate of 5.5%, applicable for 1 year). The carrying amount of the investment at 31 March 2011 will be £ nil (opening carrying amount of £4,500,000 plus interest of £247,500 credited to the Income and Expenditure Account, less the final payment of £4,747,500 to be received from the administrator on 31 March 2011, the payment comprising £4,500,000 principal and £247,500 interest). The accounting entries required in 2010/11 will be:

Dr	Financial Assets (interest credited)	£247,500
Cr	Income & Expenditure Account (interest credited)	£247,500
Dr	Cash (payment received)	£4,747,500
Cr	Financial Assets (payment received)	£4,747,500

## Example B

An authority invested £10 million in XYZ Bank for six months at 5.5%, repayable on 31 December 2008. At 31 December 2008 the carrying amount of the investment would be £10,275,000 (the interest receivable of £275,000 being recognised in the Income and Expenditure Account). The bank has experienced financial difficulties. The administrator has announced (prior to the 2008/09 accounts being closed) that 45% of the principal will be repaid on 31 March 2010 and 45% on 31 March 2011. Interest will be paid on 31 March of each year (including 2009), but will be based on the revised value of the investment (i.e. £9 million, 90% of the original investment). Interest will not be paid on interest accrued but not paid.

The investment will be impaired as at 31 December 2008. The recoverable amount is calculated by discounting the cash flows from 31 December 2008. As the first payment will be made one quarter of a year from the date of impairment, the discounted cash flow is calculated using a quarterly discounting framework. Because of this, interest should also be credited to the Income and Expenditure Account (and the carrying amount of the investment adjusted) on a quarterly basis. As the investment's interest rate is 5.5% annually, the quarterly interest rate can be calculated as one quarter of this (1.375%). The recoverable amount is therefore calculated as follows:

Date	Discount Factor	Repayment	Present Value
31 March 2009 (1 <sup>st</sup> quarter)	0.98644	£371,250	£366,215
31 March 2010 (5 <sup>th</sup> quarter)	0.93400	£4,995,000	£4,665,317
31 March 2011 (9 <sup>th</sup> quarter)	0.88435	£4,747,500	£4,198,432
TOTAL			£9,229,964

The recoverable amount of the investment is £9,229,964 which is £1,045,036 less than the carrying amount of the investment. An impairment of £1,045,036 would therefore need to be recognised in the Income and Expenditure Account in 2008/09. As the impairment is recognised at 31 December 2008, interest of £275,000 would be recognised up to 31 December 2008, and interest of £126,912 (the carrying amount of £9,229,964 multiplied by the quarterly interest rate of 1.375%) would be recognised between 31 December 2008 and 31 March 2009. Interest of £371,250 would be received from the administrator on 31 March 2009 (based on 9 months simple interest on 90% of the original investment - £9,000,000 multiplied by 5.5% interest for  $\frac{3}{4}$  of a year).

The accounting entries required in 2008/09 will be:

Dr	Income & Expenditure Account (impairment)	£1,045,036
Cr	Financial Assets (or the Allowance Account if one is being used) (impairment)	£1,045,036
Dr	Cash (interest received)	£371,250
Cr	Financial Assets (interest received)	£371,250

Dr	Financial Assets (income credited to I&E December 2008)	£275,000
Cr	Income & Expenditure Account (income credited to I&E December 2008)	£275,000
Dr	Financial Assets (income credited to I&E March 2009)	£126,912
Cr	Income & Expenditure Account (income credited to I&E March 2009)	£126,912

The carrying amount of the investment at 31 March 2009 will be £8,985,626 (£10,000,000 original investment, plus interest of £275,000 credited December 2008 and interest of £126,912 credited March 2009, less impairment of £1,045,036 less cash received of £371,250).

The amortised cost method requires that interest continue to be credited to the Income and Expenditure Account until the financial instrument has been derecognised. This will be the point at which the final payment in respect of the investment is received. As final payment will not be received until 31 March 2011, interest will be credited to the Income and Expenditure Account in both 2009/10 and 2010/11. As the discounted cash flow calculation uses a quarterly framework, interest should be applied quarterly (using the quarterly interest rate applied to the revised carrying amount) to ensure the value of the investment is brought to zero at the point the investment is derecognised. The process is shown in the table below.

Date		Amount
31 March 2009	Carrying Amount	£8,985,626
30 June 2009	Interest Credited to I&E Account	£123,552
30 June 2009	Carrying Amount	£9,109,178
30 September 2009	Interest Credited to I&E Account	£125,251
30 September 2009	Carrying Amount	£9,234,429
31 December 2009	Interest Credited to I&E Account	£126,973
31 December 2009	Carrying Amount	£9,361,402
31 March 2010	Interest Credited to I&E Account	£128,719
31 March 2010	Payment Received from Administrator	£4,995,000
31 March 2010	Carrying Amount	£4,495,121
30 June 2010	Interest Credited to I&E Account	£61,808
30 June 2010	Carrying Amount	£4,556,929
30 September 2010	Interest Credited to I&E Account	£62,658
30 September 2010	Carrying Amount	£4,619,587
31 December 2010	Interest Credited to I&E Account	£63,519
31 December 2010	Carrying Amount	£4,683,106
31 March 2011	Interest Credited to I&E Account	£64,394
31 March 2011	Payment Received from Administrator	£4,747,500
31 March 2011	Carrying Amount	£0

Interest credited to the Income and Expenditure Account will be £504,495 in 2009/10 and £252,379 in 2010/11. These figures can be identified in the table above.

The accounting entries required in 2009/10 will be:

Dr	Financial Assets (interest credited)	£504,495
Cr	Income & Expenditure Account (interest credited)	£504,495
Dr	Cash (payment received)	£4,995,000
Cr	Financial Assets (payment received)	£4,995,000

The accounting entries required in 2010/11 will be:

Dr	Financial Assets (interest credited)	£252,379
Cr	Income & Expenditure Account (interest credited)	£252,379
Dr	Cash (payment received)	£4,747,500
Cr	Financial Assets (payment received)	£4,747,500

The carrying amount will be £4,495,121 at 31 March 2010 and £nil at 31 March 2011. These figures can be identified from the table above.

## Example C

An authority invested £10 million in XYZ Bank for six months at 5.5%, repayable on 31 December 2008. At 31 December 2008 the carrying amount of the investment would be £10,275,000 (the interest receivable of £275,000 being recognised in the Income and Expenditure Account). The bank has experienced financial difficulties. The administrator has announced (prior to the 2008/09 accounts being closed) that 45% of the principal will be repaid on 31 March 2010 and either 40% or 45% on 31 March 2011. Interest will be paid on 31 March of each year (including 2009); interest will initially be based on the lower estimate of the principal that will be repaid (i.e. 85% or £8.5 million), with additional interest payable on March 2011 if the higher estimate is paid. Interest will not be paid on interest accrued but not paid. Based on other pronouncements made by the administrator, the authority assesses that each option is equally probable, and therefore assigns a 50% probability to each option.

The recoverable amount can therefore be calculated as follows, using the present value calculations:

Date	Option 1 – 40% repayment on 31 March 2011	Option 2 – 45% repayment on 31 March 2011 (plus backlog interest)
31 March 2009 (interest based on 85% in both options)	£345,869	£345,869
31 March 2010 (45% plus interest in both options)	£4,639,632	£4,639,632
31 March 2011	£3,731,940	£4,240,992
Total Present Value	£8,717,441	£9,226,493
Probability of Option Occurring	50%	50%
Present Value x Probability	£4,358,720	£4,613,247

The best estimate of the recoverable amount will be the weighted average of each option – the sum of the present value of each option multiplied by the probability of that option occurring. This gives a recoverable amount of £8,971,967 (£4,358,721 + £4,613,247). This recoverable amount is £1,303,033 less than the carrying amount of the investment. An impairment of £1,303,033 would therefore need to be recognised in the Income and Expenditure Account in 2008/09.

The carrying amount at 31 March 2009 will be £8,744,707 (carrying amount at 31 December 2008 of £8,971,967 plus one quarter's interest of £123,365 less the interest receivable from the administrator of £350,625 - based on £8,500,000 and  $\frac{3}{4}$  of a year's interest at 5.5% per annum).

Interest would be credited to the Income and Expenditure Account in 2009/10 and 2010/11. As in Example B above, quarterly discounting will be required, and the accounting treatment is shown below. As the final payment is uncertain, both options are shown.

Date		Amount
31 March 2009	Carrying Amount	£8,744,707
30 June 2009	Interest Credited to I&E Account	£120,240
30 June 2009	Carrying Amount	£8,864,947
30 September 2009	Interest Credited to I&E Account	£121,893
30 September 2009	Carrying Amount	£8,986,840
31 December 2009	Interest Credited to I&E Account	£123,569
31 December 2009	Carrying Amount	£9,110,409
31 March 2010	Interest Credited to I&E Account	£125,268
31 March 2010	Payment Received from Administrator	£4,967,500
31 March 2010	Carrying Amount	£4,268,177
30 June 2010	Interest Credited to I&E Account	£58,687
30 June 2010	Carrying Amount	£4,326,864
30 September 2010	Interest Credited to I&E Account	£59,494
30 September 2010	Carrying Amount	£4,386,358
31 December 2010	Interest Credited to I&E Account	£60,312
31 December 2010	Carrying Amount	£4,446,670
31 March 2011	Interest Credited to I&E Account	£61,142
31 March 2011	Carrying Amount (before repayment)	£4,507,812

Because the impairment was based on the weighted average of two options, the final payment will not match the carrying amount at 31 March 2011 prior to the payment being received. This will result in a difference, giving either an additional impairment or a gain; both will be recognised in the Income and Expenditure Account.

If the final payment is based on the 40% final payment option (85% total repayment), the final repayment from the administrator would be £4,220,000. This would result in a balance of £287,812 being left on the financial asset account; an additional impairment would be required to charge this to the Income and Expenditure Account.

If the final payment is based on the 45% final payment option (90% total repayment), there would also be backlog interest included in the final payment, giving a final payment of £4,795,625. This would result in a credit balance of £287,813 being left on the financial asset account; this gain should be recognised in the Income and Expenditure Account.

The accounting entries that will be required in 2008/09 are as follows

Dr	Income & Expenditure Account (impairment)	£1,303,033
Cr	Financial Assets (or the Allowance Account if one is being used) (impairment)	£1,303,033
Dr	Cash (interest received)	£350,625
Cr	Financial Assets (interest received)	£350,625

Dr	Financial Assets (income credited to I&E December 2008)	£275,000
Cr	Income & Expenditure Account (income credited to I&E December 2008)	£275,000
Dr	Financial Assets (income credited to I&E March 2009)	£123,365
Cr	Income & Expenditure Account (income credited to I&E March 2009)	£123,365

The accounting entries that will be required for 2009/10 are as follow

Dr	Financial Assets (interest credited)	£490,970
Cr	Income & Expenditure Account (interest credited)	£490,970
Dr	Cash (payment received)	£4,967,500
Cr	Financial Assets (payment received)	£4,967,500

The accounting entries that will be required for 2010/11 are as follows:

Option 1 - final payment of 40%

Dr	Financial Assets (interest credited)	£239,635
Cr	Income & Expenditure Account (interest credited)	£239,635
Dr	Cash (payment received)	£4,220,000
Cr	Financial Assets (payment received)	£4,220,000
Dr	Income & Expenditure Account (additional impairment)	£287,812
Cr	Financial Assets (additional impairment)	£287,812

Option 2 - final payment of 45% plus backlog interest

Dr	Financial Assets (interest credited)	£239,635
Cr	Income & Expenditure Account (interest credited)	£239,635
Dr	Cash (payment received)	£4,795,625
Cr	Financial Assets (payment received)	£4,795,625
Dr	Financial Assets (gain transferred to I&E)	£287,813
Cr	Income & Expenditure Account (gain transferred to I&E)	£287,813

## Calculation of Average Rate of Interest in respect of Income Receivable (Item 8 Credit)

This Appendix provides details of the two methods of calculating the average rate of interest in respect of interest receivable by the authority, which is used in determining the Item 8 credit. The wording of the Item 8 determination refers to "interest receivable", which suggests that the rate should be based on the accrued income in relation to the contractual cash flows of an investment. This is the method that would have been used in the SORP to measure investment income prior to the introduction of the financial instrument standards (FRS 25, FRS 26 and FRS 29) in the 2007 SORP. However, the wording of the determination also refers to "proper practice", which suggests that the method used in the current SORP to measure interest income (the amortised cost method) should be used in determining the rate.

As the wording of the determination can be used to support the use of both methods, this Appendix provides details of how the average rate of interest in respect of interest receivable by the authority is calculated under both methods. Worked examples are provided showing the calculation of the average rate of interest using both methods.

CLG and the Welsh Assembly Government are actively considering which method should be used (or whether both are acceptable), and both will consider issuing further guidance. Prior to calculating the average rate of interest, authorities should confirm their proposed method is consistent with any guidance issued by CLG or the Welsh Assembly Government, or in the absence of any guidance discuss the matter with their external auditors.

### Method 1 - Accrued income based on contractual cash flows

Under this method, the level of investment used in calculating the average rate of interest is the principal amount of an investment. At the point at which an investment becomes impaired, the principal amount of the investment is adjusted to the amount of principal that the authority expects to recover (if any). Interest is accrued, based on the contractual cash flows of the investment. At the point at which an investment becomes impaired, the amount of interest is adjusted to the amount of interest that the authority expects to recover (if any).

### Method 2 - Amortised Cost method

Under this method, the level of investment used in calculating the average rate of interest is the amortised cost of an investment. For short term investments, the principal amount of the investment can be used as an estimate of the amortised cost, producing the same figure as the first method. However, at the point at which an investment becomes impaired, the investment should be measured on an amortised cost basis, which will produce a different figure to that produced by the first method. Interest income is credited to the Income and Expenditure Account on an amortised cost basis. For short term investments, this will be the same as the accrued interest used in the first method. However, at the point at which an investment becomes impaired, interest income should be credited to the Income and Expenditure Account on an amortised cost basis, which will produce a different figure to that produced by the first method.

Example (i)

An authority invests an average of approximately £100 million throughout the year. Interest rates for the investments vary from 5.5% to 6.5% throughout the year. Included in these investments is a deposit with ABC Bank of £10 million at 6%, made at the start of August for 4 months. At the start of October, the investment is impaired. The authority will receive a principal repayment of £9 million at the end of March, but will not receive any interest.

Had the investment not been impaired, the average rate of interest would have been calculated as follows (monthly averages have been used to simplify the calculation):

Month	Investments (excluding impaired)	Average Rate	Interest on investments	Impaired investment	Interest on impaired investment	Total Investment	Total Interest
April	98,700,000	6.18%	508,305			98,700,000	508,305
May	98,900,000	6.20%	510,983			98,900,000	510,983
June	95,600,000	5.87%	467,643			95,600,000	467,643
July	104,200,000	6.40%	555,733			104,200,000	555,733
August	89,500,000	5.85%	436,313	10,000,000	50,000	99,500,000	486,313
September	93,500,000	5.97%	465,163	10,000,000	50,000	103,500,000	515,163
October	87,200,000	5.97%	433,820	10,000,000	50,000	97,200,000	483,820
November	87,600,000	6.04%	440,920	10,000,000	50,000	97,600,000	490,920
December	101,600,000	6.44%	545,253			101,600,000	545,253
January	99,300,000	6.39%	528,773			99,300,000	528,773
February	104,600,000	5.77%	502,952			104,600,000	502,952
March	96,700,000	6.49%	522,986			96,700,000	522,986

The average investment throughout the year is £99,783,333. Total interest in the year is £6,118,844. This gives an average interest rate of 6.132%.

The impairment takes place at the start of October. The principal is not repaid until the end of March. The assumption used when calculating the revised average rate of interest (using both methods) is that the authority had planned to reinvest the principal amount of the impaired investment (£10 million) for the rest of the year. The level of investments (excluding the impaired investment) is therefore reduced by £10 million from December to March (the average rate on investments during those periods remains the same).

Method 1 - Accrued income based on contractual cash flows

Using this method, the impaired investment is included in the investment total at the principal amount during August and September. When the investment is impaired, the amount is adjusted to the amount of the repayment; this amount remains in the investment total until the repayment is received (end of March). No interest will be received, and interest on the investment is therefore excluded from the calculation. The revised calculation is as follows:

Month	Investments (excluding impaired)	Average Rate	Interest on investments	Impaired investment	Interest on impaired investment	Total Investment	Total Interest
April	98,700,000	6.18%	508,305			98,700,000	508,305
May	98,900,000	6.20%	510,983			98,900,000	510,983
June	95,600,000	5.87%	467,643			95,600,000	467,643
July	104,200,000	6.40%	555,733			104,200,000	555,733
August	89,500,000	5.85%	436,313	10,000,000		99,500,000	436,313
September	93,500,000	5.97%	465,163	10,000,000		103,500,000	465,163
October	87,200,000	5.97%	433,820	9,000,000		96,200,000	433,820
November	87,600,000	6.04%	440,920	9,000,000		96,600,000	440,920
December	91,600,000	6.44%	491,587	9,000,000		100,600,000	491,587
January	89,300,000	6.39%	475,523	9,000,000		98,300,000	475,523
February	94,600,000	5.77%	454,868	9,000,000		103,600,000	454,868
March	86,700,000	6.49%	468,903	9,000,000		95,700,000	468,903

The average investment throughout the year is £99,283,333. Total interest in the year is £5,709,761. This gives an average interest rate of 5.751%.

## Method 2 - Amortised Cost method

Using this method, the impaired investment is included in the investment total at the principal amount during August and September. When the investment is impaired, the amount is adjusted to the amortised cost; the amortised cost is adjusted each month until the repayment is received (end of March). Interest is credited to the Income and Expenditure Account each month on an amortised cost basis.

The amortised cost of the impaired investment, calculated using monthly discounting, is as follows:

The monthly interest rate is 0.5% (6% annual interest rate divided by 12). Payment of £9 million will be received six months after the impairment takes place (beginning of October). The amortised cost is the value of the payment multiplied by the discount rate for a payment in six months time at 0.5% monthly (0.97052). This gives an amortised cost for the investment of £8,734,663 at the beginning of October. Interest accrued to the end of September on the investment would be credited to the Income and Expenditure Account, based on the principal amount invested. Interest would continue to be credited to the Income and Expenditure Account following the impairment, based on the amortised cost. The process is shown in the table below:

Month	Opening Balance	Investment	Impairment	Interest credited to I&E Account	Repayment	Closing Balance
August		10,000,000				10,000,000
September	10,000,000			100,000		10,100,000
October (beginning)	10,100,000		(1,365,337)			8,734,663
October	8,734,663			43,673		8,778,336
November	8,778,336			43,892		8,822,228
December	8,822,228			44,111		8,866,339
January	8,866,339			44,332		8,910,671
February	8,910,671			44,553		8,955,224
March	8,955,224			44,776	(9,000,000)	0

The amortised cost amounts are then used in the calculation of the average rate of interest. The calculation is as follows:

Month	Investments (excluding impaired)	Average Rate	Interest on investments	Impaired investment	Interest on impaired investment	Total Investment	Total Interest
April	98,700,000	6.18%	508,305			98,700,000	508,305
May	98,900,000	6.20%	510,983			98,900,000	510,983
June	95,600,000	5.87%	467,643			95,600,000	467,643
July	104,200,000	6.40%	555,733			104,200,000	555,733
August	89,500,000	5.85%	436,313	10,000,000	50,000*	99,500,000	486,313
September	93,500,000	5.97%	465,163	10,000,000	50,000*	103,500,000	515,163
October	87,200,000	5.97%	433,820	8,734,663	43,673	95,934,663	477,493
November	87,600,000	6.04%	440,920	8,778,336	43,892	96,378,336	484,812
December	91,600,000	6.44%	491,587	8,822,228	44,111	100,422,228	535,698
January	89,300,000	6.39%	475,523	8,866,339	44,332	98,166,339	519,855
February	94,600,000	5.77%	454,868	8,910,671	44,553	103,510,671	499,421
March	86,700,000	6.49%	468,903	8,955,224	44,776	95,655,224	513,679

\* Interest to the point of impairment would be credited at the end of September, but is shown here accrued over August and September for comparison with the original calculation and Method 1

The average investment throughout the year is £99,205,622. Total interest in the year is £6,075,098. This gives an average interest rate of 6.124%.

Example (ii)

An authority invests an average of approximately £100 million throughout the year. Interest rates for the investments vary from 5.5% to 6.5% throughout the year. Included in these investments is a deposit with ABC Bank of £10 million at 6%, made at the start of August for 8 months. At the start of October, the investment is impaired. The authority will receive a principal repayment of £9 million at the end of March (the maturity date), along with interest on the amount to be repaid (a total repayment of £9,360,000).

Had the investment not been impaired, the average rate of interest would have been calculated as follows (monthly averages have been used to simplify the calculation):

Month	Investments (excluding impaired)	Average Rate	Interest on investments	Impaired investment	Interest on impaired investment	Total Investment	Total Interest
April	98,700,000	6.18%	508,305			98,700,000	508,305
May	98,900,000	6.20%	510,983			98,900,000	510,983
June	95,600,000	5.87%	467,643			95,600,000	467,643
July	104,200,000	6.40%	555,733			104,200,000	555,733
August	89,500,000	5.85%	436,313	10,000,000	50,000	99,500,000	486,313
September	93,500,000	5.97%	465,163	10,000,000	50,000	103,500,000	515,163
October	87,200,000	5.97%	433,820	10,000,000	50,000	97,200,000	483,820
November	87,600,000	6.04%	440,920	10,000,000	50,000	97,600,000	490,920
December	91,600,000	6.44%	491,587	10,000,000	50,000	101,600,000	541,587
January	89,300,000	6.39%	475,523	10,000,000	50,000	99,300,000	525,523
February	94,600,000	5.77%	454,868	10,000,000	50,000	104,600,000	504,868
March	86,700,000	6.49%	468,903	10,000,000	50,000	96,700,000	518,903

The average investment throughout the year is £99,783,333. Total interest in the year is £6,109,761. This gives an average interest rate of 6.123%.

As the impaired investment is due to mature at the end of March, no assumptions regarding reinvestment are required.

Method 1 - Accrued income based on contractual cash flows

Using this method, the impaired investment is included in the investment total at the principal amount during August and September. When the investment is impaired, the amount is adjusted to the amount of the repayment; this amount remains in the investment total until the repayment is received (end of March). Interest is included in the calculation, based on the amount to be repaid. The revised calculation is as follows:

Month	Investments (excluding impaired)	Average Rate	Interest on investments	Impaired investment	Interest on impaired investment	Total Investment	Total Interest
April	98,700,000	6.18%	508,305			98,700,000	508,305
May	98,900,000	6.20%	510,983			98,900,000	510,983
June	95,600,000	5.87%	467,643			95,600,000	467,643
July	104,200,000	6.40%	555,733			104,200,000	555,733
August	89,500,000	5.85%	436,313	10,000,000	45,000	99,500,000	481,313
September	93,500,000	5.97%	465,163	10,000,000	45,000	103,500,000	510,163
October	87,200,000	5.97%	433,820	9,000,000	45,000	96,200,000	478,820
November	87,600,000	6.04%	440,920	9,000,000	45,000	96,600,000	485,920
December	91,600,000	6.44%	491,587	9,000,000	45,000	100,600,000	536,587
January	89,300,000	6.39%	475,523	9,000,000	45,000	98,300,000	520,523
February	94,600,000	5.77%	454,868	9,000,000	45,000	103,600,000	499,868
March	86,700,000	6.49%	468,903	9,000,000	45,000	95,700,000	513,903

The average investment throughout the year is £99,283,333. Total interest in the year is £6,069,761. This gives an average interest rate of 6.114%.

## Method 2 - Amortised Cost method

Using this method, the impaired investment is included in the investment total at the principal amount during August and September. When the investment is impaired, the amount is adjusted to the amortised cost; the amortised cost is adjusted each month until the repayment is received (end of March). Interest is credited to the Income and Expenditure Account each month on an amortised cost basis.

The amortised cost of the impaired investment, calculated using monthly discounting, is as follows:

The monthly interest rate is 0.5% (6% annual interest rate divided by 12). Payment of £9,360,000 will be received six months after the impairment takes place (beginning of October). The amortised cost is the value of the payment multiplied by the discount rate for a payment in six months time at 0.5% monthly (0.97052). This gives an amortised cost for the investment of £ 9,084,049 at the beginning of October. Interest accrued to the end of September on the investment would be credited to the Income and Expenditure Account, based on the principal amount invested. Interest would continue to be credited to the Income and Expenditure Account following the impairment, based on the amortised cost. The process is shown in the table below:

Month	Opening Balance	Investment	Impairment	Interest credited to I&E Account	Repayment	Closing Balance
August		10,000,000				10,000,000
September	10,000,000			100,000		10,100,000
October (beginning)	10,100,000		(1,015,951)			9,084,049
October	9,084,049			45,420		9,129,469
November	9,129,469			45,647		9,175,116
December	9,175,116			45,876		9,220,992
January	9,220,992			46,105		9,267,097
February	9,267,097			46,335		9,313,432
March	9,313,432			46,568	(9,360,000)	0

The amortised cost amounts are then used in the calculation of the average rate of interest. The calculation is as follows:

Month	Investments (excluding impaired)	Average Rate	Interest on investments	Impaired investment	Interest on impaired investment	Total Investment	Total Interest
April	98,700,000	6.18%	508,305			98,700,000	508,305
May	98,900,000	6.20%	510,983			98,900,000	510,983
June	95,600,000	5.87%	467,643			95,600,000	467,643
July	104,200,000	6.40%	555,733			104,200,000	555,733
August	89,500,000	5.85%	436,313	10,000,000	50,000*	99,500,000	486,313
September	93,500,000	5.97%	465,163	10,000,000	50,000*	103,500,000	515,163
October	87,200,000	5.97%	433,820	9,084,049	45,420	96,284,049	479,240
November	87,600,000	6.04%	440,920	9,129,469	45,647	96,729,469	486,567
December	91,600,000	6.44%	491,587	9,175,116	45,876	100,775,116	537,463
January	89,300,000	6.39%	475,523	9,220,992	46,105	98,520,992	521,628
February	94,600,000	5.77%	454,868	9,267,097	46,335	103,867,097	501,203
March	86,700,000	6.49%	468,903	9,313,432	46,568	96,013,432	515,471

\* Interest to the point of impairment would be credited at the end of September, but is shown here accrued over August and September for comparison with the original calculation and Method 1

The average investment throughout the year is £99,382,513. Total interest in the year is £6,085,712. This gives an average interest rate of 6.124%.