CIPFA & ICAEW
REPRESENTATION 84/22

FUTURE OF THE IFRS 9 STATUTORY OVERRIDE

Issued 7 October 2022

CIPFA and ICAEW welcome the opportunity to respond to the Department for Levelling Up, Housing and Communities (DLUHC) consultation on the future of the IFRS 9 *Financial Instruments* statutory override, a copy of which is available from this link.

CIPFA and ICAEW have submitted a joint response because we share the view that the override on pooled investments should end as soon as possible. Fair value movements on investments in pooled funds should impact the general fund of local authorities. Both institutes believe that high standards in financial reporting help improve financial and risk management.

We have come to the joint view that the override should end because:

- IFRS 9 was specifically designed to improve the understanding of risks from investments and there is a concern that the override partly undermines this;
- local authorities are investing in the same sorts of instruments as 'Professional Investors' (under MIFID II) and should be held to the same high standards of financial reporting;
- not recognising the fair value movements from pooled funds undermines effective risk management;
- the override risks incentivising investments in pooled funds at the expense of a local authority assessing the suitability of investing in these instruments; and
- we do not agree with the argument that removing the override would incentivise riskier investments because these decisions should be driven by prudent treasury management practices and in accordance with applicable statutory codes and guidance.

If DLUHC decides to extend the override, we recommend this extension is time limited, with a relatively short time frame and limited in scope because:

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- there is a significant stranded-asset[1] risk that could increase over time;
- local authorities may not have adequately prepared for losses that could crystalise on the unwinding or maturity of a fund; and
- it risks removing the incentive for effective risk management.

If a local authority has issues arising from changes to the regulations, it is invited to contact CIPFA at policy.technical@cipfa.org.

This joint response has been prepared by CIPFA's Policy and Technical directorate and ICAEW's Public Sector team within its Reputation and Influence department. It follows consultation with ICAEW's Public Sector Advisory Group and ICAEW's Financial Reporting Committee, as well as CIPFA's Public Financial Management Board.

For questions on this response please contact the ICAEW Public Sector team at representations@icaew.com quoting REP 76/22 or CIPFA at policy.technical@cipfa.org.

About CIPFA
CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money.

cipfa.org

About ICAEW
ICAEW is a global professional body for chartered accountants and represents more than 195,300 members and students worldwide. Founded in 1880, it has a long history of serving the public interest and continues to work with governments, regulators and business leaders globally. ICAEW gives talented individuals the skills and values they need to build sustainable businesses, economies and societies, while holding them to the highest standards of professional competency and conduct. ICAEW's Public Sector team supports its many members working in and with the public sector to deliver public priorities and sustainable public finances.

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[1] The risk that the value of the underlying assets in an investment will not recover to their historical value, possibly as a result of obsolescence, dilapidation or a permanent decline in the market for these assets.

Question 1: In your view, what should the future of the IFRS 9 override be post March 2023 [elapse/extend/make permanent]? Please set out your rationale.

1. We have not selected one of the choices above as our preference is that there should not be a statutory override of IFRS 9 and that fair value movements on pooled investments should be recognised in the general fund.
2. However, our answer for 6a) sets out a position for an extension that would be limited both in scope and time. We believe that this is a pragmatic suggestion that would be consistent with the rationale for the original override and the principle of risk reduction. We are particularly opposed to a further open-ended extension of the override, since this would not resolve the issues raised by the consultation and would create further uncertainty for local authorities.
3. CIPFA and ICAEW support basing the *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code) on International Financial Reporting Standards (IFRS) because IFRS are globally recognised for their high standards in financial reporting. We believe that statutory overrides should be limited to either where the circumstances or transactions of local government are different from other entities and make the requirements of the particular IFRS unsuitable or where there is a need to address perverse outcomes that impact local government finances.
4. We do not believe this is the case with investments in pooled funds, since local authorities are investing in the same sort of instruments used by ‘Professional Investors’ (under MIFID II) and, therefore, should be required to comply with the same high standards of financial reporting and risk management. Economic volatility, including that arising from the COVID-19 pandemic, the financial pressures facing many local authorities and recent high-profile financial management failures in local government highlight the importance of high-quality reporting and risk management in this sector.
5. IFRS 9 was introduced to tackle a deficiency in financial reporting that meant investment risks were not fully reported. While the override has no impact on the valuations of investment reported on the balance sheet, we are concerned that the statutory override results in less transparent reporting as the fair value movements are not immediately charged to the general fund. This increases the risk that local authorities might not be able to properly manage their investment risks, because it means movements do not have an immediate impact on usable reserves. The override also exposes local authorities to the risk of significant impacts on the general fund in the future, such as when the investments mature or they choose to withdraw.
6. CIPFA and ICAEW also believe that by artificially insulating a local authority’s general fund from the immediate impact of the risks in pooled investments, maintaining the override is in danger of incentivising a certain type of investment. We share the government’s position that by ending the override there is a low risk that this would incentivise riskier investments, given

the requirements of the Government's Statutory Investment Guidance, the CIPFA Treasury Management Code and the CIPFA Prudential Code[2].

7. Provided that the treasury management and other risks are appropriately managed in accordance with the Treasury Management Code, it is still appropriate for local authorities to invest in pooled funds. The value of the largest pooled funds has increased over the period of the override so many of the concerns about fair value losses impacting local authority resources appear not to have come to fruition.

Question 2: Please describe any financial consequences for your authority if the statutory override is allowed to elapse from 31 March 2023?

N/A

Question 3: What are the advantages and disadvantages of investing in pooled investment funds for your LA?

8. CIPFA and ICAEW consider that the advantages include diversifying investments and income sources and the ability to generate potentially higher returns than cash. Investment in pooled funds also mitigates some of the risk of investing in illiquid assets as they allow for a diversified portfolio of assets at different stages of the asset management cycle. Pooled funds hold a mixture of market assets and a float of cash. Authorities with a long-term cash surplus and a capacity to absorb movements in asset values could find these funds especially useful. In any case, treasury managers at local authorities should fully understand the investment instrument, the underlying assets and the potential for adverse movements.

9. The main disadvantage is that investing in pooled funds carries risk as with any investment in illiquid assets. Pooled funds are complex, and it can be more difficult to understand the nature of the instruments and the underlying assets. The risks are particularly high for local authorities with no long-term cash surplus and little or no capacity to absorb any loss on the initial investment.

10. CIPFA would advise local authorities in the above situation to avoid these types of instruments, since the investment horizon is not appropriate for a short-term investor.

Question 4: How would removing the statutory override change your current approach to investing in pooled investment funds?

11. CIPFA and ICAEW are of the view that removing the statutory override should make local authorities more aware of risks in how they approach investing in these funds.

12. There are some authorities with a genuine long-term cash surplus for whom these funds may be a suitable asset class to invest in. Our response is not intended to discourage responsible investments. However, we believe removing the override should incentivise authorities to assess the risks and their capacity to absorb any losses before making these sorts of investments. Furthermore, authorities choosing to invest in these funds should have appropriate risk management arrangements in place to cover movements in valuations.

Question 5: Assuming the statutory override elapses March 2023, what impact might this change have on your audit process?

13. CIPFA and ICAEW do not consider that the impact on the audit process should dictate whether local authorities engage in best practice in financial, risk management and high-quality financial reporting.

14. The ending of the statutory override would have transactional impact on ensuring balances within reserves (fair value movements) are transferred to the General Fund and that resulting financial risks are appropriately reported in the financial statements. There is very little in the regulations about what happens once the override has elapsed, but CIPFA anticipates that it

[2] The Treasury Management in the public services Code of practice and cross-sectoral guidance notes (2021) and the Prudential Code for capital finance in local authorities (2021)

will provide appropriate guidance via its Bulletins or through the Code Guidance Notes and would be happy to discuss this with government.

15. This will have a one-off impact on accounts preparers and auditors but should not have a significant or lasting impact on the audit. The removal of the override does not change the value of the pooled investments that need to be recognised in the balance sheet nor the fair value movements that should be shown in the surplus or deficit on the provision of services.

16. The removal of the override and the result that movements in fair value have a more immediate impact could result in increased focus on the fair value movements by both accounts' preparers and auditors. Both CIPFA and ICAEW believe this is justified because of the risk involved in investments of this nature and the importance of the fair value measurement to adequate risk management. The auditors may also consider whether a local authority is maintaining adequate reserves to manage the risk from investment as part of their consideration of financial sustainability for the assessment of value for money arrangements.

17. One potential issue is that it is an area of judgement whether designation of pooled fund investments at fair value through other comprehensive income (FVTOCI) is permitted by the Code and the potential for differences of interpretation amongst auditors and accounts' preparers. CIPFA believes that designating the instruments at FVTOCI would be inappropriate as this accounting policy choice should be limited to strategic investments.

18. Additionally, designating investments in pooled funds at FVTOCI would be a less transparent means of reporting the financial performance and impact of these financial instruments. This would mean that fair value movements are not recognised in the surplus or deficit on the provision of services and that there would only be a movement in usable reserves when the surplus or deficit on the financial instrument is recognised when the investment matures, or if an authority withdraws from the fund.

Question 6(a): Assuming that the statutory override is continued beyond March 2023, do think it should be time-limited or permanent? Please set out your rationale?

(b) If you think it should be time-limited, what do you consider the appropriate length of time it should be extended?

19. As stated in our answer to Q1, our preference is that there should not be an override for investments in pooled funds. However, we recognise that the economic uncertainty caused by COVID-19 has temporarily disrupted the market for many of the assets within pooled funds. Therefore, we can see the justification for a strictly time-limited extension that provides time for investors to adequately manage any changes in the risk profile based on the original term of the statutory override.

20. We recommend that the government considers an extension that expires after two years, on 31st March 2025 and is clear in any accompanying commentary that there will not be a further extension. Our view is that the extension should only cover financial instruments made prior to the initial introduction of the override on 1 April 2018. Local authorities would have to explain this different treatment clearly within their accounting policies.

21. The rationale for a time and scope-limited extension is that authorities have had a period of five years to manage their existing exposure and the risks associated with it. Further investments should have been made with the knowledge that the override was time-limited and that fair value movements would affect usable reserves in the future as is set out in paragraph 19 of the consultation documents.

Question 7(a): If applicable, has your authority taken steps to reduce its exposure to the risks associated with pooled investment funds ahead of the statutory override potentially ending 31 March 2023? Please provide details.

(b) If your authority has not taken steps to reduce its exposure to risks from pooled investment funds, please set out the rationale for this.

N/A

Question 8: Do you agree that by not recognising the fair value movement of pooled investment funds this reduces effective risk management and potentially creates future risks? Please provide details.

22. Yes. We agree with this statement.
23. Although we understand that the aim of many investors in these funds is not to exit in a loss position, economic volatility means this is not always possible. Furthermore, a significant “stranded asset” risk may arise over time which could have a material impact on the financial statements. The stranded asset risks occur when the value of the underlying assets will not recover to their historical value, possibly as a result of obsolescence, dilapidation or a permanent decline in the market for these assets. This would then mean the fund would not recover its value and local authorities could face significant losses.
24. There is a risk that the override means that local authorities have not adequately prepared to cope with losses when the investment matures, is sold or the local authority withdraws from the fund. It is easier to respond to these sorts of risks by building up reserves over time or, where necessary, making appropriate budgetary changes, as would be encouraged by IFRS 9. Effective reserves management should prevent local authorities from the need to make significant budgetary changes as a result of short-term fluctuations in the value of pooled fund investments.
25. The override could also obscure increasing fair value losses and the final impact this might have on the resources of the authority. Making the override permanent would perpetuate this situation and risks removing the incentive for authorities to have a keen focus on the fair value movements manage their risk.

Question 9: What is the fair value of your authorities pooled investment fund investments as at 31 March 2022?

N/A

Question 10: Please set out the value of the gains/losses from your authorities investments in pooled investment funds for 2019/20, 2020/21, 2021/22 recognised under proper practices. Please give both absolute value and as percentage movement for each year.

N/A

Question 11: What is the balance on the unusable reserve as created by the statutory override as at March 2022?

N/A