CIPFA The Chartered Institute of Public Finance & Accountancy

LAAP bulletin 82

guidance on the impairment of deposits with Icelandic Banks

update No. 2

May 2010

The Local Authority Accounting Panel issues LAAP Bulletins to assist practitioners with the application of the requirements of the SORP, BVACOP and Prudential Code, and to provide advice on emerging or urgent accounting issues. Bulletins provide influential guidance that is intended to be best practice, but are not prescriptive and do not have the formal status of the SORP, BVACOP or Prudential Code.

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background

1. LAAP Bulletin 82 provided advice on estimating the impairments to be recognised in relation to deposits in Icelandic banks. This guidance was based on published information at the date the bulletin was issued, and a further update was issued in September 2009. Since that date, further information has become available. This update sets out the position at the end of May 2010 and provides advice on estimating the impairments based on the latest position and on the accounting issues arising from revising the assessment of the impairment. Authorities should note that the Responsible Financial Officer (Proper Officer in Scotland) has ultimate responsibility for determining an appropriate provision for impairment, and will therefore need to come to his or her own decision as to the reliance to be placed on the guidance provided in this Update.

revised assessment of impairment – accounting issues

2. FRS 3 states that the majority of prior period items arise from corrections and adjustments that are the natural result of estimates inherent in the accounting process. Such adjustments constitute normal transactions for the year in which they are identified, and should be accounted for accordingly.

3. The reassessment of the value (recoverable amount) of a deposit in an Icelandic bank will be a change in an accounting estimate, and should (where required) be accounted for in the year in which the revised estimate is made. A reassessment of the recoverable amount at 31 March 2010 will therefore be accounted for in the 2009/10 accounts, and the 2008/09 accounts should not be restated for the change.

4. Prior to any reassessment, the carrying amount of the deposit on the balance sheet will be the balance at 31 March 2009, plus interest credited to the Income and Expenditure Account during 2009/10, less any repayments received during 2009/10.

5. The value (recoverable amount) of the deposit at 31 March 2010 should then be reassessed. Paragraph 4.67 of the SORP (in line with paragraph 63 of FRS 26) states that the recoverable amount of financial assets carried at amortised cost is the present value of the expected future cash flows discounted at the instrument's original effective interest rate.

6. Authorities will therefore need to assess the future cash flows as at 31 March 2010. This will need to be based on the latest available information. The cash flow calculations carried out when assessing the value of the deposit at 31 March 2009 will need to be amended for revised estimates and actual cash movements in 2009/10; the discounting will need to be amended to reflect the fact the cash flows are one year closer.

7. Paragraph 65 of FRS 26 states that an impairment loss can be reversed where the decrease in the impairment loss 'can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating). Revised estimates of the recoverable amounts that could lead to a reversal of will arise from a number of factors including:

    - Repayments received for a greater amount than initially announced by the administrators;

    - Repayments received earlier than initially announced by the administrators; and

    - Announcements by the administrators that a greater percentage of the banks assets will be recovered than originally anticipated.

8. The Local Authority Accounting Panel has concluded that these factors amount to an event (or events) occurring after the impairment was recognised. As such, the impairment loss should be reversed.

9. Where the revised estimate of the recoverable amount is less than the carrying amount of the deposit, a further impairment should be recognised.

10. Any difference between the carrying amount of the deposit and the revised assessment of the recoverable amount should therefore be debited or credited to the Income and Expenditure Account (as a revised estimate of the impairment). The entries required are as follows:

> Dr / Cr Income and Expenditure Account
> Cr / Dr Financial Asset
>
> With the difference between the carrying amount of the deposit and the revised estimate of the recoverable amount

11. An authority may have previously elected to make use of regulations or statutory guidance to defer the impact of an impairment loss on the General Fund. Where the authority estimates that part of that loss has now been reversed, and credits the Income and Expenditure Account accordingly, the credit will need to be transferred to the Financial Instruments Adjustment Account as required by regulations or statutory guidance. The entries required are as follows:

> Dr General Fund (and shown as a reconciling item in the Statement of Movement on the General Fund Balance)
> Cr Financial Instrument Adjustment Account
>
> With the transfer under the regulations or statutory guidance

12. Where the authority estimates that an impairment loss has increased, and has charged the Income and Expenditure Account with this increased loss, the authority may elect to transfer the increased impairment loss to the Financial Instruments Adjustment Account as permitted by regulations or statutory guidance. The entries required are as follows:

> Dr Financial Instrument Adjustment Account
> Cr General Fund (and shown as a reconciling item in the Statement of Movement on the General Fund Balance)
>
> With the transfer under the regulations or statutory guidance

13. Updated estimates of the amounts that may be recovered from each of the banks can be found in paragraphs 25 – 61 of this Update.

disposal of a deposit

14. This section of the Update is based on the premise that authorities can assign their interests in a deposit to a third party. Whilst the Local Authority Accounting Panel understands this is the case, legal advice has not been sought and any authority that intends to dispose of a deposit to a third party should satisfy itself that it is legally able to do so.

15. Where an authority has accepted an offer from a third party to purchase the deposit, the authority should credit the Income and Expenditure Account with interest (calculated using the amortised cost method) up to the date of the disposal. Where the authority has elected to rely on regulations or statutory guidance to defer the impact on the General Fund, the interest will need to be transferred to the Financial Instrument Adjustment Account. The entries required are as follows:

Dr Financial Asset Cr Income and Expenditure Account With the interest to be credited for the year Dr General Fund Cr Financial Instrument Adjustment Account With the transfer required under regulations or statutory guidance

16. The authority will recognise any gain or loss on the disposal of the deposit in the Income and Expenditure Account. This gain or loss does not, in accordance with paragraph 26 of FRS 26, constitute a change in the impairment, and is therefore not transferred to the Financial Instruments Adjustment Account. When the cash for the sale is received, this should be credited to the Financial Asset. The entries required are as follows:

Dr Cash Cr Financial Asset With the proceeds of the sale Dr / Cr Income and Expenditure Account Cr / Dr Financial Asset With the difference between the carrying amount of the deposit and the proceeds of the sale

17. These entries will write out the deposit from the balance sheet.

18. Authorities will also need to make the disclosures required by the SORP in respect of impaired financial assets (see LAAP Bulletin 79).

capitalisation directions (England only)

19. In England, some authorities have been granted capitalisation directions in respect of losses in Icelandic banks. The directions can be used to capitalise impairment losses charged to the General Fund in 2009/10. In Wales, no capitalisation directions have been issued, however the regulation permitting authorities to defer the impact on the General Fund has been extended until 2011/12. In England, no extension has been given. In Scotland no extension arrangements have been made regarding the statutory guidance (Finance Circular 4/2009), nor has any 'consent to borrow' been issued in respect of non-recovery of Icelandic Bank deposits in 2009/10. The Scottish Government has advised that the Scottish Ministers have agreed that a general consent to borrow scheme should be developed for Scotland. It is anticipated that this scheme will be available in 2010/11 and applications for Icelandic bank losses will be considered under this scheme. Scottish Ministers will also be considering the merits of extending the statutory guidance beyond 2010/11.

20. Authorities granted capitalisation directions may have previously relied on regulations to defer the impact of the impairment on the General Fund. These authorities will therefore need to ensure that any losses the authority intends to capitalise using the direction are charged to the General Fund in 2009/10; this will require an appropriate amount to be transferred from the Financial Instruments Adjustment Account to the General Fund:

Dr General Fund
Cr Financial Instrument Adjustment Account

With the transfer required under regulations

21. Authorities should note that the capitalisation directions specify in precise terms what expenditure can be capitalised using the direction, up to a specified maximum amount. The Local Authority Accounting Panel understands that the terms of such capitalisation directions typically refer to 'expenditure which is incurred by the authority on impairment of Icelandic investments' as being potentially eligible to be capitalised, require the expenditure capitalised to exceed a minimum level determined mathematically and also to be 'properly incurred during the financial year that began on 1 April 2009'. Authorities should ensure that any expenditure capitalised meets the terms of the relevant direction.

22. It should be noted that the direction specifies a total amount that the authority may capitalise, rather than an amount per bank. Therefore, if the expected losses with some banks have increased but the expected losses in other banks have decreased, the authority can offset these changes (provided it does not capitalise more than its total expected losses or the amount of the capitalisation direction, whichever is lower).

23. The use of a capitalisation direction will result in Revenue Expenditure Funded from Capital Under Statute. The expected losses capitalised under the direction should therefore be transferred to the Capital Adjustment Account:

Dr Capital Adjustment Account
Cr General Fund (and shown as a reconciling item in the Statement of Movement on the General Fund Balance)

With the amount of the expected losses capitalised under a direction

24. For capital control purposes, this amount will be treated as capital expenditure and will need to be funded. This may be through the use of capital receipts or capital grants (where the terms of the grant permit its use for this purpose) or by increasing the capital financing requirement (resulting in increased MRP charges in future years).

updated estimates

25. The following paragraphs set out the latest information in respect of each bank.

Heritable Bank plc

26. At the time LAAP Bulletin 82 Update 1 was issued, the total amount to be received was estimated to be between 70% and 80% of the claim. The administrators issued the latest creditors report in January 2010[1]. This report noted that current projections suggest a base case return to creditors of 79 to 85 pence in the pound.

27. At the time LAAP Bulletin 82 Update 1 was issued, the first interim payment had been made in July 2009 for 16.13% of the claim. Since then, further dividends have been paid (12.66% in December 2009 and 6.19% in March 2010), bringing the total dividends paid to date to 34.98% of the claim.

28. In view of this information, LAAP recommends that the following repayment schedule is used to estimate the recoverable amount at 31 March 2010. The schedule is based on expected total dividends of 84.98% of the claim.

[1] http://www.heritable.co.uk/Uploads/Documents/news/Heritable_Bank_Plc_Creditors_Update_2010.01.28.pdf

29. This estimate is at the top end of the range quoted by the administrators. This is in line with the approach taken in LAAP Bulletin 82, where it was noted that a strategy of winding up the bank by 2012 was expected to produce a return at the top end of the range; a strategy of winding up the bank before 2012 would lead to lower returns. On this basis, the Local Authority Accounting Panel considers that a recovery at the top end of the estimate is the most likely outcome, and this therefore forms its best estimate.

Date	Repayment	Date	Repayment
June 2010	5%	September 2011	5%
September 2010	5%	December 2011	5%
December 2010	5%	March 2012	5%
March 2011	5%	June 2012	5%
June 2011	5%	September 2012	5%

Kaupthing Singer & Friedlander Ltd

30. At the time LAAP Bulletin 82 Update 1 was issued, the total amount to be received was estimated to be 50% of the claim. The administrators issued the latest creditors report in April 2010[2]. This report noted that the current estimated total distributions to unsecured creditors should be in the range of 65p to 78p in the pound.

31. At the time LAAP Bulletin 82 Update 1 was issued, the first interim payment had been made in July 2009 for 20% of the claim. Since then, further dividends have been paid (10% in December 2009 and 5% in March 2010), bringing the total dividends paid to date to 35% of the claim.

32. In view of this information, LAAP recommends that the following repayment schedule is used to estimate the recoverable amount at 31 March 2010. The schedule is based on expected total dividends of 71% of the claim.

33. When LAAP Bulletin 82 was issued, the administrators quoted an estimated recoverable amount of at least 50% rather than a range. The latest creditors' report does not include any information that indicates any particular value in the range is more likely than other values. The Local Authority Accounting Panel's best estimate of the recoverable amount is therefore based on the mid point of the range, in line with the requirements of paragraph AG86 of the Application Guidance to FRS 26 (see paragraphs 25 – 26 of LAAP Bulletin 82).

Date	Repayment	Date	Repayment
July 2010	6%	January 2012	6%
January 2011	6%	July 2012	6%
July 2011	6%	January 2013	6%

Iceland-domiciled banks

34. For the two banks domiciled in Iceland (Glitnir Bank hf and Landsbanki Islands hf), a number of complicating factors need to be taken into consideration. These factors are common to both banks.

[2] http://www.kaupthingsingers.co.uk/Pages/CustomerCreditorInformation.asp

35. The SORP and FRS 26 require authorities to make their best estimate of the recoverable amount. The following paragraphs consider how these factors will influence a 'best estimate'.

36. Authorities should note that using the mid point of a range may not be appropriate, as paragraph 39 of IAS 37 (see paragraph 26 of LAAP Bulletin 82) requires the use of the mid point where 'there is a continuous range of possible outcomes, and each point in that range is as likely as any other.' This is not the case when considering, for example, priority status, where there are two discrete possibilities rather than a continuous range.

37. Paragraph 40 of FRS 12 (which is consistent with IAS 37) states that:

'Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.'

38. Whilst this paragraph is not referenced in FRS 26, authorities may find the guidance helpful if they conclude that it would be appropriate for the estimated impairment to take account of a range of estimates rather than being based solely on the most likely outcome.

39. Authorities should also note that paragraph AG84 of FRS 26 includes the following sentence:

'As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price.'

Where an authority had an offer to purchase a deposit at the balance sheet date that was sufficiently robust for accounting purposes (ie, where the offer was for a specific price – or a narrow range of prices – and was not subject to change), that price may therefore be helpful in establishing the authority's best estimate.

priority status

40. Previous advice has been based on the assumption that local authority deposits with the banks had priority status, and would therefore be repaid ahead of any creditors that did not have priority status. This was based on the legal advice obtained by local authorities, and on announcements made by the banks.

41. The Glitnir Winding-Up Board has since expressed the view that local authority deposits do not have priority status[3]. This view contrasts with the view expressed by the Landsbanki Winding-Up Board that local authority deposits do have priority status. Local authorities' legal advice remains that deposits have priority status under Icelandic law.

42. Decisions about the priority status of local authority deposits will be made by the Icelandic courts. There is no evidence to suggest that Glitnir and Landsbanki accepted deposits on different terms, and therefore it is expected that the courts will come to the same conclusion in both cases. Authorities will need to reflect this when considering their best estimate of the recoverable amounts of their deposits. Allowing for the court cases to be heard, and for the appeals process to run its course, it is considered unlikely that there will be a settled position on priority status before the second quarter of 2011.

[3] http://www.glitnirbank.com/home/356-8685-claims-lodged-in-glitnirs-winding-up.html

43. Given the uncertainty introduced by the Glitnir Winding-Up Board announcement, each authority will need to carefully consider the evidence available to them from the Winding-Up Boards and their legal advisors.

44. The Local Authority Accounting Panel considers, on the basis of the legal advice obtained by local authorities and advice provided by the Local Government Association, that it remains the most likely outcome that the claims will enjoy priority status.

45. Based on this assessment, the Local Authority Accounting Panel recommends that the estimated recoverable amount to be included in the balance sheet is based on the assumption that local authority deposits will enjoy priority status. However, the panel also accepts that some authorities may take a different view. In such cases, authorities may wish to refer to the guidance in paragraph 40 of FRS 12 (see paragraph 37 above).

46. The updated estimates below include estimated profiles based on both scenarios. As stated in paragraph 45, the Local Authority Accounting Panel recommends that the estimated recoverable amount to be included in the balance sheet is based on the assumption that local authority deposits will enjoy priority status. However, an authority may decide to estimate the recoverable amount by reference to the relative probabilities of the different scenarios occurring. When estimating the recoverable amount to be included in the balance sheet in this manner, authorities should multiply the recoverable amount generated by estimated cash flows for each scenario by the probability for that scenario occurring. The results should then be summed to give the recoverable amount to be included in the balance sheet.

47. For example, a claim amount of £1,000,000 on 22 April 2009 with Landsbanki would, assuming an interest rate of 5% for the deposit, give a recoverable amount of approximately £746,000 if the deposit enjoyed priority status; and approximately £301,000 if it did not. The calculation of the recoverable amount to be included in the balance sheet (based on a 67% probability that deposits enjoy priority status) is therefore:

(£746,000 x 67% = £499,820) + (£301,000 x 33% = £99,330) = £599,150

48. Authorities should note that these probabilities are provided for illustrative purposes only; they do not amount to a recommendation from the Local Authority Accounting Panel.

recovery of interest

49. LAAP Bulletin 82 Update 1 recommended that, where a deposit's maturity date was before 22 April 2009, interest (at 22%, the Icelandic penalty rate of interest) between the maturity date and 22 April 2009 should be included in the claim amount. This recommendation was based on local authorities' legal advice at the time, and noted that the Winding-Up Boards had yet to clarify the position regarding penalty interest.

50. No further information regarding interest beyond the maturity date has been received. It therefore remains possible that the final settlement of claims may include interest (up to 22 April 2009) at 22%. However, the Local Authority Accounting Panel considers this to be less likely than was the case when Update 1 was issued; other possible outcomes that should therefore be considered when making a best estimate are that interest is included at the contractual rate; or that no interest after the maturity date is included. It is also possible that an alternative, lower, penalty rate would be used.

51. In the absence of any information on which to assess probabilities, the Local Authority Accounting Panel recommends that the contractual interest rate is used (up to 22 April 2009), as a known rate that falls between the extremes of the range.

exchange rate risk

52. Deposits with the Icelandic-domiciled banks were converted to Icelandic Krona (ISK) on 22 April 2009. The exchange rate at this date was 190.62 ISK per £. Repayments by the banks will be based on the value of the deposit in ISK; the sterling value received by authorities will depend on the prevailing exchange rate, and may therefore be lower than the equivalent value on 22 April 2009.

53. However, most of the banks assets are in currencies other than ISK. The amount of ISK that the banks will recover from their creditors will also vary with exchange rate movements. Movements that reduce the sterling value of authorities' repayments may lead to an increased recovery (in ISK) by the banks where the ISK experiences similar movements against other currencies. This would allow for an increased percentage repayment. The exception to this scenario is that if deposits with Glitnir receive priority status, the estimated repayment is 100% of the claim; increased recovery of the banks assets will therefore not lead to an increased percentage repayment.

54. These exchange rate risks would normally be taken into account when estimating future cash flows. However, currency restrictions mean that there is no futures market for ISK, and it is therefore impossible to price the ISK exchange rate risk. An analysis of movements to date indicates that the two risks are reasonably equally balanced, and any net increase or decrease in the amount of repayments received by authorities is not expected to be material, although it is possible this could change in the future. This Update assumes that exchange rate risk can be ignored when estimating future cash flows.

Glitnir Bank hf

55. The latest information available regarding Glitnir is contained in the 2009 accounts[4]. The accounts indicate that Glitnir has approximately ISK 808bn in assets to meet liabilities of ISK 2,791bn. Creditors are claiming priority status for approximately ISK 255bn of liabilities, although no decision has yet been made as to the status of those claims.

56. Based on this information, it remains the case that if local authority deposits retain priority status, 100% of claims will be repaid. No payment is expected to be received prior to the court cases and any appeals in respect of priority status being heard. It is therefore estimated that the earliest date by which payment could be made is the end of June 2011.

57. If local authority deposits do not enjoy priority status, the expected recovery is approximately 29%. Approximately one quarter of the amount expected to be recovered is related to the value of Glitnir's investments in the successor bank Islandsbanki and in the Luxembourg SPVs. It would not be unreasonable to expect that these investments would not be realised for five years (say by October 2015). In the absence of any other information on which to base a repayment profile in the scenario where local authority deposits with Glitnir do not enjoy preferential status, it is recommended that the remaining amounts are assumed to be recovered evenly between October 2011 and October 2015.

58. Based on the above analysis, the estimated repayment profiles (depending on whether priority status is assumed or not) are shown below.

[4] http://www.glitnirbank.com/images/stories/Glitnir_bank_Financial_Statements_2009.pdf

Date	Repayment (No Priority Status)	Repayment (Priority Status)	Date	Repayment (No Priority Status)	Repayment (Priority Status)
June 2011	0%	100%	October 2013	4.35%	0%
October 2011	4.35%	0%	October 2014	4.35%	0%
October 2012	4.35%	0%	October 2015	11.60%	0%

Landsbanki Islands hf

59. The latest creditors' report[5] was issued on 26 March 2010. This confirms (see Chapter 8, pages 44-46) that a settlement has been reached between Landsbanki and the successor bank in Iceland (NBI) about the way in which the successor will compensate Landsbanki for the assets taken over.

60. Compensation is being provided through a series of interest-bearing bonds in a range of currencies. Some information regarding the bonds is available in the creditors' report, and further information is included in the Statement of Assets Report[6] presented at the second creditors' meeting in February 2010 (see page 10).

61. A model of the estimated recovery from Landsbanki is included in the Impairment Calculator Update 2 spreadsheet. The model produces the following estimated recovery profile; two percentages are shown, depending on whether priority status is assumed or not.

Date	Repayment (No Priority Status)	Repayment (Priority Status)	Date	Repayment (No Priority Status)	Repayment (Priority Status)
October 2011	8.93%	22.17%	October 2015	3.57%	8.87%
October 2012	3.57%	8.87%	October 2016	3.57%	8.87%
October 2013	3.57%	8.87%	October 2017	3.57%	8.87%
October 2014	3.57%	8.87%	October 2018	7.84%	19.47%

presentation

62. Paragraphs 156 – 161 of LAAP Bulletin 84 give guidance on the presentation of elements of financial instruments as either short-term (current) or long-term (non-current). In accordance with this guidance, amounts due to be received in 2010/11 should be presented within short-term investments, with the remainder being presented within long-term investments.

[5] http://www.lbi.is/Uploads/document/Creditors_report_1.2010.pdf
[6] http://www.lbi.is/Uploads/document/LBI_2nd_creditors_meeting_presentation_24022010.pdf