Chorley Council

Report of	Meeting	Date
Chief Finance Officer	Governance Committee	23 September 2015

CHANGE IN ACCOUNTING POLICY 2015/16

PURPOSE OF REPORT

1. To justify and recommend a change in accounting policy from 2015/16 onwards, to permit capitalisation of borrowing costs (fees and interest) in respect of major capital projects up to the point that the qualifying assets become operational.

RECOMMENDATION(S)

2. That from 1 April 2015 the Council should adopt the accounting policy of capitalising borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset; where costs are incurred in more than one financial year before an asset becomes operational; and where the budgeted prudential borrowing required to finance the asset is £4m or more.

EXECUTIVE SUMMARY OF REPORT

3. Under the Council's current accounting policy of "expensing" borrowing costs, such costs arising when prudential borrowing is incurred for the acquisition, construction, or production of a qualifying asset are charged to the General Fund revenue budget in advance of an asset becoming operational.

4. Adopting a policy of capitalising borrowing costs for qualifying assets would mean that they would form part of the cost of that asset, and would be charged to the revenue budget when the asset becomes operational as part of the financing costs. In some cases, the financing costs would in effect be met from rental income that would be receivable only when the assets were ready for use. The policy would avoid borrowing costs being charged to the revenue budget before receipt of the rental income in such instances.

Confidential report Please bold as appropriate	Yes	**No**

CORPORATE PRIORITIES

5. This report relates to the following Strategic Objectives:

Involving residents in improving their local area and equality of access for all		A strong local economy	
Clean, safe and healthy communities		An ambitious council that does more to meet the needs of residents and the local area	√

BACKGROUND

6. Accounting policies are presented in the annual Statement of Accounts, and are approved when the statement itself is approved. However, the accounting policies can be approved in advance of approval of the statement. This report proposes a change to the treatment of borrowing costs incurred during the construction phase of new assets up to the point that assets become operational. Implementation of the policy would have implications for the Council's General Fund revenue budget, therefore this report has been presented at the earliest opportunity rather than waiting twelve months to recommend that the change should be implemented retrospectively.

7. Section 4.8 of the Charted Institute of Public Finance and Accountancy's Code of Practice on Accounting in the United Kingdom (the Code) allows authorities to adopt a policy of capitalising borrowing costs incurred whilst an asset is being constructed or acquired. In England and Wales, the Code is part of the 'proper practices' requirements governing the preparation of an authority's Statement of Accounts referred to in section 21 of the Local Government Act 2003. All authorities to which section 21 applies that are required to prepare a Statement of Account by the Accounts and Audit Regulations under section 27 of the Audit Commission Act 1998 therefore have a statutory duty to comply with Code requirements.

CAPITALISATION OF BORROWING COSTS

8. IAS 23 "Borrowing Costs" requires borrowing costs in respect of qualifying assets to be capitalised. The Code permits (but does not require) authorities to select an accounting policy of expensing these costs. Where an expensing policy is adopted, as it has been by Chorley Council, the Code requires all borrowing costs (interest and other costs that an authority incurs in connection with the borrowing of funds, such as transactions fees) to be recognised as an expense in the year that they are incurred. In brief, this means that any borrowing costs incurred whilst an asset is being constructed or acquired would be charged to the General Fund's revenue budget, and in the Statement of Accounts would be recognised in the Comprehensive Income and Expenditure Statement within Financing and Investment Income and Expenditure.

9. The Council may include large capital projects in the Capital Programme which could take more than one financial year before the assets are operational. In some cases, the intention may be that the financing costs of the assets should be funded from rental income that would begin to be received only when the assets are completed. If the existing policy of expensing borrowing costs continues, the effect would be that interest and fees would be charged to the General Fund's revenue budget before any rental income is received to cover the financing costs. This would occur if the Council borrows in stages to fund the land assembly, construction or conversion phases of new assets, rather than funding the expenditure from internal cash balances. Temporary use of internal cash balances would help to reduce borrowing costs, but the cash available may not be sufficient in the case of large capital projects. Adopting the accounting policy of capitalising borrowing costs would avoid the revenue budget suffering costs before an asset is available for use, and this would be combined with the Minimum Revenue Provision "holiday" permitted by the Council's MRP Policy.

10. Where an authority has an accounting policy of capitalising borrowing costs, the costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. This is permitted when it is probable that they will result in future economic benefits or service potential to the authority and the costs can be measured reliably. Other borrowing costs are recognised as an expense. Broadly, this means that the Capital Programme budgets for qualifying assets would be increased to reflect inclusion of the borrowing costs; but that borrowing costs relating to previous capital

expenditure or not relating to qualifying assets would continue to be charged to the revenue budget.

11. To measure the borrowing costs to be capitalised, to the extent that the Council borrows funds generally and uses them for the purpose of obtaining a qualifying asset, it shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing cost that are outstanding during the period, other than the borrowing costs made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs to be capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period. The Council shall cease capitalising borrowing costs when substantially all of the activities necessary to prepare the qualifying asset for its intended use (or sale) are complete.

12. Borrowing costs need not be capitalised for all capital schemes to be financed by prudential borrowing. This would not be necessary for lower value assets which come into use within one financial year. It is therefore recommended that the policy should apply only to

13. The disclosure requirement of the Code is that in the Statement of Accounts the Council shall disclose the amount of borrowing costs capitalised during the period; and their capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

IMPLICATIONS OF REPORT

14. This report has implications in the following areas and the relevant Directors' comments are included:

Finance	√	Customer Services	
Human Resources		Equality and Diversity	
Legal		Integrated Impact Assessment required?	
No significant implications in this area		Policy and Communications	

COMMENTS OF THE STATUTORY FINANCE OFFICER

15. The proposed change in accounting policy is permitted by the CIPFA Code of Practice on Accounting in the UK. The effect of the change would be to permit borrowing costs (fees and interest) to be added to the capital cost of large capital projects up to the point the qualifying assets become operational. This is desirable in the case of assets to be funded by rental income once they are completed and are operational, in order to avoid costs being charged to the General Fund revenue budget before the assets are in use.

COMMENTS OF THE MONITORING OFFICER

16. The legal basis of capitalising borrowing costs in these circumstances is explained in paragraph 7 of the report.

GARY HALL
CHIEF EXECUTIVE AND CHIEF FINANCE OFFICER

Background Papers			
Document	**Date**	**File**	**Place of Inspection**
CIPFA Code of Practice on Accounting in the United Kingdom 2014/15	April 2014	Electronic document	Town Hall

Report Author	Ext	Date	Doc ID
Michael Jackson	5490	9 September 2015	Change in Accounting Policy 2015-16.docx