Finance and Resources Committee

10.00am, Thursday 21 January 2021

Change in accounting policy – capitalisation of interest costs

Executive/routine	**Executive**
Wards	
Council Commitments	

1. Recommendations

1.1 The Finance and Resources Committee is recommended to:

1.1.1 Agree the proposed change to accounting policy to allow interest to be capitalised under specific circumstances set out in the report and where the interest costs incurred during the construction phase exceed £2m.

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Report

Change in accounting policy – capitalisation of interest costs

2. Executive Summary

2.1 The purpose of this report is to seek Members' approval to change the accounting policy to allow interest to be capitalised under specific circumstances for expenditure on qualifying assets.

3. Background

3.1 The Council's accounting policies are aligned with International Accounting Standards.

3.2 Interest costs arising from capital expenditure are accounted for as revenue expenditure in the year in which they arise, with the costs being met through the loan charges budget, which is augmented by budget virements from services, where projects are funded on a prudential basis, through either income streams or revenue savings.

3.3 The Council's Financial Statements are prepared in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom.

3.4 Capitalisation of interest was referred to in the Trams to Newhaven report to the Transport and Environment Committee at its meeting on 12 November 2020, which noted that the Council was considering changing its policy to allow for capitalisation during construction periods.

4. Main report

4.1 A review has been undertaken on the suitability of the Council's current accounting policy for interest taking into consideration the requirements of large-scale projects, spanning more than one year of construction, and funded from future revenue streams. The Council currently accounts for loan charges in the year in which they arise. However, the opportunity to capitalise borrowing costs exists.

4.2 There is provision within the Accounting Code of Practice to enable an authority to implement a policy of capitalising borrowing costs. In order to do so, the authority will need to determine (i) an interpretation of what constitutes a qualifying asset and (ii) the borrowing costs that are to be capitalised. The following is an extract from the Code of Practice on Local Authority Accounting in the United Kingdom – Guidance Notes for Practitioners 2019/20 Accounts:

Qualifying assets

M6 The definition of qualifying assets in paragraph 4.8.2.3 of the Code refers simply to assets that necessarily take a substantial period of time to get ready for their intended use or sale. Taking into account materiality, the practical outcome of this definition is that an asset will take a substantial period of time to get ready if the period is sufficiently long for a material balance of borrowing costs to accrue.

M7 The implication is that if it would be material for an authority to accrue borrowing costs, the Code will support it doing so. Authorities will then set a prospective de minimis limit, based on the amount of borrowing costs estimated to be accrued and/or the period the asset is expected to take to get ready.

4.3 Adopting such a policy for interest costs associated with qualifying assets would allow costs to be better matched to income streams and would have a positive impact on wider financial sustainability issues in the short to medium term, noting that the overall loan charges associated with any project would be higher over the full repayment period. A de minimis limit of £2m for interest costs is proposed, taking account of the size and nature of the projects to which, the policy would be applied.

4.4 The Council's current policy on measurement of fixed assets reads as follows:

- **Measurement**
  Infrastructure, community assets and assets under construction are measured at historical cost.

4.5 The proposed wording, taking account of the recommendation in this report, would be as follows:

Measurement

Infrastructure assets, community assets and assets under construction are initially measured at historic cost, comprising their purchase price and any costs attributable to brining the assets into use for their intended purpose.

4.6 Where assets under construction will take a substantial period of time to be ready for their intended use, and the borrowing costs are to be met from associated income streams, then the interest costs that are directly attributable to the construction of the asset will be capitalised, subject to a de minimis limit of £2m of interest costs per asset under construction.

4.7 The Trams to Newhaven project meets the stated definition and will be accounted for on the basis of the changes set out in this report, if the recommendations are approved.

4.8 Members are asked to note that the capitalisation of interest costs represents the funding arrangements for a project and that any capitalised interest costs would sit outwith the approved capital budget for construction of a project but will be included in the revenue implications of the project.

4.9 Members are asked to note that the change in policy, if approved, would be applied retrospectively to the 2019/20 financial year.

5. Next Steps

5.1 If the report recommendations are approved, interest costs will be retrospectively capitalised in 2019/20 for the Trams to Newhaven project, with the changes reflected and reported in the 2020/21 Financial Statements.

6. Financial impact

6.1 The financial impact will depend on the borrowing costs associated with construction period of any qualifying asset.

6.2 The immediate financial impact would be to capitalise circa £1.2m of interest in the 2019/20 Financial Statements, with the amount for 2020/21 to be determined at the end of the financial year. There will be no impact on the revenue outturn arising directly from this change in policy, as interest costs had been met from reserves earmarked for the tram project, and these monies will be returned to the earmarked reserve.

7. Stakeholder/Community Impact

7.1 An informal discussion has been held with the Council’s external auditor in respect of this proposed change in accounting policy.

8. Background reading/external references

8.1 Not applicable.

9. Appendices

9.1 None