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# London Borough of Hillingdon

## Update report to the Audit Committee on the 2009/10 Audit

## Valuation of Icelandic Investments

Audit Committee 28 June 2010
PART II – MEMBERS ONLY

# Executive summary

We presented our Planning Report on the 2009/10 audit of London Borough of Hillingdon ("the Authority") to the Audit Committee on 11 March 2010. That report set out our identified key audit risks for the 2009/10 year, one of which was the valuation of Icelandic investments. This report sets out the Authority's position at 31 March 2009, and the latest guidance available in relation to Icelandic investments.

| | Description | Detail |
|---|---|---|
| **31 March 2009 position** | The Authority held £20 million of investments across two Icelandic banks. At 31 March a net impairment of £4.95 million was recorded in the accounts. | Page 2 |
| **2009/10 events** | We understand that £5.3 million has been returned to the Authority from Heritable Bank during the year. In applying the latest guidance, the Authority has calculated that the impairment held against its Icelandic deposits should be reduced by £0.8 million notional interest for the year, and £0.5 million following revised estimates of the future amounts which will be received from each bank. | Page 3 |
| **Latest guidance** | The latest guidance issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) indicates that the amounts recoverable from Heritable Bank may be 84.98% and from Landsbanki may be 94.98% (compared to 80% and 83% respectively at September 2009).<br>Technical guidance on how to account for revisions to the impairments held against Icelandic investments has been provided for Authorities to follow, which is outlines on page 4. | Page 3 |

# 1. Icelandic Investments

**Audit Risk**

Specific audit risks are identified during audit planning, and represent key issues of which we are aware which in our view lead to a heightened level of risk of misstatement in the Statement of Accounts. We identified the valuation of Icelandic investments as an audit risk with the following explanation:

- The 2008/09 financial statements included an impairment of approximately £4.95 million in relation to Icelandic investments. The value of the impairment at 31 March 2010 will need to be considered based on the latest available information. Changes in the value of the impairment will need to be accounted for in accordance with technical accounting guidance. In addition, the ongoing accounting treatment of the impairment beyond 31 March 2010 is subject to a decision by DCLG.

This is an issue which involves degrees of uncertainty and some complex technical accounting and disclosures being required. Our response to this risk is to review the Authority's calculations and assumptions in connection with the impairment of their investments in Icelandic banks. We will also review correspondence between the Authority and DCLG on the future accounting treatment.

**2008/09 position**

The 2008/09 Statement of Accounts disclosed that the Authority had £20 million invested in Icelandic banks when they were placed into administration. This consisted of £15 million deposited with Heritable Bank and £5 million with Landsbanki. The most up to date information available at the time of signing those accounts indicated that the Authority could expect £16.15m of these deposits to be returned to it, leading to a £3.85 million impairment being required. The guidance around accounting for the impairment required the Authority to apply a 'discounted cash flow' calculation to which notional interest on the deposits would be applied over time until the matter is finalised. This means that an impairment of £4.98 million was recorded in the Income and Expenditure account, net of £0.65 million notional interest for the year.

Regulations put in place in 2008/09 allowed Authorities to defer the impact of any required impairments on the general fund by reversing the cost out of Income and Expenditure and applying it to a Financial Instrument Adjustment Account.

# 1. Icelandic Investments (continued)

**2009/10 update**

We understand from discussions with management and review of Council meeting minutes that the following key events relating to the Authority's Icelandic investments took place during the year:

- £5.3 million was received in three instalments from Heritable Bank. This has not yet been audited, but represents a reduction in the Council's exposure.

- £0.8 million was posted to Income and Expenditure and to the Financial Instrument Adjustment Account to reflect notional interest credits on the outstanding balances. This reduces the effect of the impairment recorded in 2008/09.

- In applying the guidance described in this document, the Authority has calculated that the impairment reflected in the 2008/09 Statement of Accounts should be reduced by £0.5 million. This has not yet been audited.

- The Authority applied to DCLG for permission to capitalise its losses in relation to Icelandic investments in order to spread the impact on the general fund over a longer time period than would otherwise be possible. DCLG has turned down the Authority's request, along with those of some other Councils. We understand that a further application may be made.

**Latest guidance – position in respect of each bank**

**Heritable Bank:** The latest guidance is that a total of 84.98% of deposits are expected to be returned from Heritable Bank. This is an improvement from the estimated 80% in September 2009 on which the impairment in the 2008/09 Statement of Accounts was based.

**Landsbanki:** Landsbanki is an Iceland domiciled bank, and the factors behind the expected recovery rate are more complicated than Heritable Bank. Iceland domiciled banks previously indicated that Local Authority investments would be given 'priority' status when repayments are awarded. This has come into question in some instances, however the Winding-Up board of Landsbanki does still consider Local Authority deposits to hold priority status. As such, a total of 94.86% of cash is expected to be recovered over the next eight years.

# 1. Icelandic Investments (continued)

**Latest guidance – impact on accounts**

The Chartered Institute of Public Finance and Accountancy (CIPFA) issued LAAP bulletin 82 'Guidance on the impairment of deposits with Icelandic Banks' in May 2009. An update to this was issued in September 2009, which was used to inform the Authority's impairment in the 2008/09 Statement of Accounts. A further update to the guidance was released in May 2010. As this is the latest available information, this is what we will assess the level of impairment recorded against the investments the 2009/10 Statement of Accounts submitted for audit. Should any further guidance become available before the conclusion of our audit, this will also be considered.

Key points within the guidance are as follows:

- The amount of each investment assessed as being recoverable is an accounting estimate. Changes in accounting estimate are accounted for in the year in which the estimate is revised, and therefore the 2008/09 accounts should not be restated for any change;
- Prior to any reassessment, the carrying value of the investments shown 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.
- The recoverable amount of the carrying value at 31 March 2010 should then be reassessed to the value at that date of the expected future cash flows (i.e. the amounts expected to be returned from each bank), discounted at the investment's original effective interest rate.
- Authorities will therefore need to re-assess the excepted future cash flows as at 31 March 2010 based on the latest available information. Calculations performed for the 2008/09 Statement of Accounts will need amended for any revised estimates as well as actual cash movements during 2009/10, as well as the fact that cash flows are one year closer.
- Accounting standards state that an impairment loss recognised in a particular year can be reversed in a future year where the decrease in impairment loss can be 'related objectively to an event occurring after the impairment was recognised'. The Local Authority Accounting Panel has concluded that where, based on the CIPFA guidance, impairment losses are less than previously calculated, they are as a result of factors occurring after the impairment was recognised, and the impairment loss should be reversed. Where the revised estimate of the recoverable amount of the investments is less than the carrying amount of the deposit, a further impairment should be recognised.

We have discussed with the finance team the release of this guidance, which they have confirmed they are aware of and have followed in the preparation of the 2009/10 draft accounts. During our audit processes we will audit the entries made in the accounts against this guidance.

# 2. Responsibility statement

This report should be read in conjunction with the "Briefing on audit matters" and our Planning Report to Audit Committee on the 2009.10 Audit, both of which were circulated to you on 11 March 2010. Collectively these set out those audit matters of governance interest which have come to our attention during the planning of our audit to date. Our audit is not designed to identify all matters that may be relevant to the board and our final report on the audit will not necessarily be a comprehensive statement of all deficiencies which may exist in internal control or of all improvements which may be made.

This report has been prepared for the Board of Directors, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose. It should not be made available to any other parties without our prior written consent.

**Deloitte LLP**

Chartered Accountants

28 June 2010