AGENDA ITEM 7

Audit Committee	**AC / 010 / 09**
Date: **25 September 2009**	

Implementation of International Financial Reporting Standards (IFRS)

Report by Chief Financial Officer

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1. Purpose of the report and Decision Areas / Recommendations

From 2010/11, local authorities' Statements of Accounts will be prepared under an International Financial Reporting Standards (IFRS) based Code of Practice on Local Authority Accounting. This is part of a wider public sector move to international standards.

The purpose of this report is to explain the implications of the transition to IFRS based accounting and to outline the process for implementing the new accounting requirements.

RECOMMENDATIONS

It is recommended that the Committee:

(i) Notes the outline project plan for implementation of IFRS based accounting (as set out within Section 12, which commences on page 10 of the Report).

(ii) Monitors progress with the transition to IFRS based accounting.

(iii) At the relevant stages in the implementation timetable, reviews the:

- IFRS accounting policies, including significant estimation techniques;
- Restated IFRS opening balance sheet, as at 1 April 2009; and
- Restated IFRS 2009/10 accounts.

2. Legal implications

The Council has a statutory duty to prepare its accounts in accordance with proper accounting practice and to have those accounts audited in accordance with the Accounts and Audit Regulations.

3. Finance and resource implications

The Council will be required to account for some transactions and balances differently under IFRS. Possible changes to legislation / statutory guidance are currently under informal consideration to determine whether mitigation is necessary.

Significant finance staff resource will be required to implement IFRS.

4. Corporate governance

There are no further issues that need to be brought to members' attention outside of those specific points included in this report.

5. Human Resource implications

There are no specific human resource issues arising from this report.

6. Risk implications

As noted in paragraph 2 above, if the accounts are not prepared on an appropriate basis, the Council will fail in its statutory duty to produce annual accounts in compliance with proper accounting practice. The production of the accounts, and the quality of those accounts, impact directly on the Council's CAA scores (Use of Resources).

7. Information Services implications

There are no specific information services implications arising from this report. However, the ability of the Council's existing financial systems (general ledger and fixed asset register) to produce or record the information required under IFRS will need to be considered as part of the implementation exercise.

8. Congestion impact

There is no impact on congestion as a result of this report.

9. Background

Local authorities are required to keep their accounts in accordance with 'proper practice'. This is defined, for the purposes of local government legislation, as meaning compliance with the terms of the CIPFA Code of Practice on Local Authority Accounting in the United Kingdom (the 'Code'), prepared by the CIPFA/LASAAC Local Authority Code Board (CIPFA/LASAAC).

The Code has historically been prepared under generally accepted accounting practice in the UK (UK GAAP). The Code that will apply to the reporting period commencing on 1 April 2010 (ie: 2010/11) will be the first one prepared directly under International Financial Reporting Standards (IFRS).

CIPFA/LASAAC has recently published an exposure draft of the IFRS-based Code and invited comments on this by **11 September 2009**. It is anticipated that the Code will be formally published in early December 2009, with detailed guidance notes to follow some time after that.

In order to address the particular circumstances of local authorities, IFRS has been interpreted or adapted by the Code for the local authority context in a number of respects:

- Some accounting options allowed under IFRS will not be permitted under the Code to ensure that all local authorities' accounts are prepared on a comparable basis.
- In some cases, IFRS's do not provide relevant guidance for the public sector context, or need to be adapted for this. In these cases, the International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board (IPSASB) are used as a source of supplementary guidance.
- Local authorities must follow a number of legislative based accounting requirements such as requirements to maintain a General Fund, Pensions Reserve and follow Capital Finance regulations. The Code covers how such legislation based requirements will be included in the Statement of Accounts.

The governance arrangements for the preparation and approval of the Code change with the move to IFRS based accounting. The Codes prepared under UK GAAP had the status of a 'Statement of Recommended Practice ' (SORP), and were prepared under the UK Accounting Standards Board (ASB) Code of Practice for the Development of Statements of Recommended Practice. With the change to an IFRS basis for the Code, the external quality oversight role previously undertaken by the ASB will be undertaken by the Financial Reporting Advisory Board (FRAB). The FRAB is an independent body that currently oversees central government and NHS accounting guidance.

10. IFRS-based Code

10.1 Overview of significant changes

Some major changes will be required to the Council's accounting practices as a consequence of the transition to IFRS. The more significant issues for the Council are as follows:

- Various changes in relation to accounting for fixed assets (see paragraph **10.2**).
- Potential recognition of PFI assets on the Council's Balance Sheet, together with the liability for the financing provided by the PFI operator (see paragraph **10.3**).
- Potential re-categorisation of operating leases as finance leases and vice versa (see paragraph **10.4**).
- New requirement to accrue for untaken holiday entitlement and other 'time off in lieu' (TOIL) (see paragraph **10.5**).
- Introduction of changes to the presentation of Financial Statements (see paragraph **10.6**).

Further comments on each of these issues are set out in the following paragraphs together with comments on other less significant changes.

10.2 Fixed Assets

There are a significant number of changes to the arrangements for accounting for fixed assets being introduced by the IFRS-based Code. The main changes are summarised as follows:

<u>Property, plant and equipment</u>

(i) The costs of an item of property, plant and equipment can only be recognised as an asset, and hence capitalised, if:

- It is probable that the future economic benefits or service potential associated with the item flow to the Council; and
- The cost or fair value[1] of the item can be measured reliably.

Costs that meet the recognition principle include initial costs of acquisition and construction, and costs incurred subsequently to enhance, replace part of, or service the asset. Currently, separate recognition criteria apply for initial and subsequent expenditure on fixed assets. This change may result in different accounting treatments to those that currently apply.

(ii) Where a component of an asset is replaced or restored, the carrying amount of the old component will now need to be de-recognised to avoid double

[1] **Fair value** is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arms length transaction.

counting and the new component reflected in the carrying amount. This accounting treatment will be applicable to enhancement expenditure incurred from 1 April 2010. Additional information will need to be collected regarding the capital programme to enable replaced components of assets to be derecognised.

(iii) Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item will need to be depreciated separately. The requirement for componentisation for depreciation purposes will be applicable to enhancements and acquisition expenditure incurred, and revaluations carried out, from 1 April 2010.

(iv) For depreciation purposes, residual values are to be based on current prices at the balance sheet date. Currently, residual values are based on prices prevailing at the date of acquisition (or revaluation) of the asset and do not take account of expected future price changes.

(v) Renewals accounting is not permitted under the Code.

(vi) Under the Code there is a clear distinction between impairment loss and revaluation loss. This was not explicit under the SORP.

<u>Investment property</u>

(vii) Investment properties are those used solely to earn rentals or for capital appreciation, or both. The Code requires investment properties to be carried at fair value; currently, such properties are carried at the lower of net current replacement cost or net realisable value.

(viii) Revaluations will be taken to the Surplus or Deficit on provision of Services rather than to the Revaluation Reserve.

<u>Intangible assets</u>

(ix) Previously, internally developed intangible assets (such as IT software) could only be capitalised where there was a readily ascertainable market value, which was rare. The Code recognises a wider range of intangible assets, which means that internally generated assets may now be recognisable, provided the recognition criteria outlined in paragraph (i) above are met. It is likely that more internally generated intangible assets will be recognised as a consequence of this change.

<u>Impairment of assets</u>

(x) Currently, impairment losses on re-valued assets arising from ‘the clear consumption of economic benefits’ are recognised in the Income and Expenditure Account (net cost of services). The Code makes no distinction between impairments due to the clear consumption of economic benefits and other impairments (ie. general fall in prices), and therefore requires all impairment losses on re-valued assets to be recognised in the Revaluation Reserve, up to the amount of the Revaluation Reserve for each respective asset, and thereafter in the Surplus or Deficit on provision of Services.

Non current assets held for sale and discontinued operations

(xi) The Code requires assets classified as 'held for sale' to be measured at the lower of its carrying value and fair value less costs to sell. Previously, assets held for sale had to be measured at market value less expected selling costs. This change will potentially result in more profits being recognised in the Comprehensive Income and Expenditure Statement.

(xii) Currently, there are no criteria that have to be met in order to classify an asset as held for sale. The Code sets out strict criteria that all have to be met before an asset can be classified as held for sale (ie: the asset must be available for immediate sale in its present condition, the sale must be highly probable, the asset must be actively marketed for a sale at a price that is reasonable in relation to its current fair value and the sale should be expected within one year from the date of classification).

(xiii) Assets classified as 'held for sale' are not subject to depreciation; previously, they were depreciated.

(xiv) Assets held for sale may now be classified as current assets where the definition of current assets is met, rather than always being classified as fixed assets.

(xv) Following reclassification, the subsequent amount of revaluation gains arising from an increase in fair value less costs to sell an asset are recognised, but not in excess of the cumulative impairment loss or revaluation loss that has been recognised.

There are two areas where CIPFA/LASAAC has been unable to finalise its proposals, as there is an ongoing debate at national or international level. These relate to borrowing costs and capital grants. The options for addressing both issues are set out in **Annex A**, together with the Council's views on the options. CIPFA has sought views on these options as part of its wider consultation on the IFRS-based Code.

10.3 PFI

IFRS-based accounting for PFI schemes has been introduced, a year ahead of other IFRS requirements, by the 2009 SORP, and therefore applies for the 2009/10 Accounts. As a consequence, there are no additional requirements being introduced by the IFRS-based Code for such schemes.

The 2009 SORP requirements are based on IFRIC 12 '*Service Concession Arrangements*'. IFRIC 12 aims to determine who controls the PFI assets for their entire useful life by tests that consider control during the service arrangements and once the concession arrangements have expired.

The Council currently has three PFI schemes (A130, Debden Park School and Clacton Secondary School) and one PPP arrangement (Tendring Primary Schools), none of which are currently reflected on the Council's Balance Sheet. It is probable that it will be necessary, as a consequence of the changes being introduced by the 2009 SORP, to recognise the assets used to deliver these PFI / PPP services on the Council's Balance Sheet, together with the liability for the financing provided by the PFI operators. Once recognised 'on Balance Sheet' the PFI / PPP contracts will be accounted for as if they were finance leases.

Regulations or statutory guidance to ameliorate any impacts on authorities' funding positions will be put in place.

10.4 Leases

Leases are classified as either finance leases[2] or operating leases[3] based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor[4] or the lessee[5]. The IFRS-based Code may result in the re-categorisation of finance leases as operating leases and vice versa. Specific changes related to leases are as follows:

(i) One of the factors that indicates a lease is a finance lease is if 'the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset'. Under the SORP, 'substantially all' was quantified as 'normally 90% or more'. This quantitative test does not apply under the Code. This means that professional judgement will be needed to assess 'substantially all'.

(ii) Currently, property leases are accounted for as a single lease. The Code will require such leases to be accounted for as separate leases of land and buildings. In some cases, this may lead to part of an existing lease being reclassified from operating to finance or vice versa.

(iii) The IFRS Code introduces a requirement to assess whether an arrangement contains the substance of a lease. Where this is the case, the Council will be required to recognise the lease and account for this in accordance with lease provisions.

(iv) The reclassification of leases in lessee accounts may mean that the charges actually made to Revenue may be out of step with those that would have resulted from the lease being otherwise classified from the outset. Reclassification of leases in lessor accounts will result in income being reclassified from revenue income to capital receipts (or vice versa). Statutory guidance is being considered to mitigate the possible impact on the General Fund of leases being re-classified.

[2] **Finance lease**: a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.
[3] **Operating lease**: a lease other than a finance lease.
[4] **Lessor**: person who grants a lease.
[5] **Lessee**: person to whom a lease is granted.

(v) The draft Code includes details of other changes, as follows:

- Finance lease interest income calculated on a net investment, rather than net cash investment basis; and
- The requirement (rather than option) to include initial direct costs in the carrying amount of some assets.

10.5 Employee benefits

The Code requires all benefits payable during employment to be accounted for in the period in which the benefits are earned by the employee. The main impact of this is likely to be in relation to staff holiday entitlement that has not been taken and is being carried to the following year. Given the number of staff employed by the Council, the recording of the appropriate number of days and the subsequent costing of this accrual could be a significant undertaking.

Regulation or statutory guidance to neutralise the impact of providing for untaken leave (and similar issues) is being considered.

10.6 Presentation of Financial Statements

The core financial statements are currently the:

- Income and Expenditure Account;
- Statement of Movement on the General Fund Balance;
- Statement of Total Recognised Gains and Losses (STRGL);
- Balance Sheet; and
- Cash Flow Statement.

Various notes are also required to be reported.

The core financial statements required by the IFRS Code are:

- **Movement in Reserves Statement** – shows the movement in the year on the different reserves held, analysed into usable and other reserves.
- **Comprehensive Income and Expenditure Statement** – shows the accounting cost in the year of providing services in accordance with generally accepted accounting practices, rather than the amount to be funded from taxation.
- **Balance Sheet** – shows the value as at the Balance Sheet date of the assets and liabilities recognised by the Council.
- **Cash Flow Statement** – shows the changes in cash and cash equivalents of the authority during the reporting period (with a revised definition of cash and cash equivalents).

The format of the new statements differs from those currently required and may require different or additional information to be collected. The notes to the accounts are also likely to include more detail than is currently required under the SORP.

Currently, the Net Cost of Services is segmentally reported on the face of the Income and Expenditure Account. The segments are based on the mandatory headings defined within the CIPFA Best Value Accounting Code of Practice (BVACOP). The IFRS based code will continue to require service information to be included on the face of the Comprehensive Income and Expenditure Statement based on the BVACOP. However, segmental reporting based on internal management arrangements will also be required as a note to the Accounts; this note will include a subjective analysis and reconciliation to the Comprehensive Income and Expenditure Statement.

10.7 Other changes

Other changes that may have some implications moving forward include:

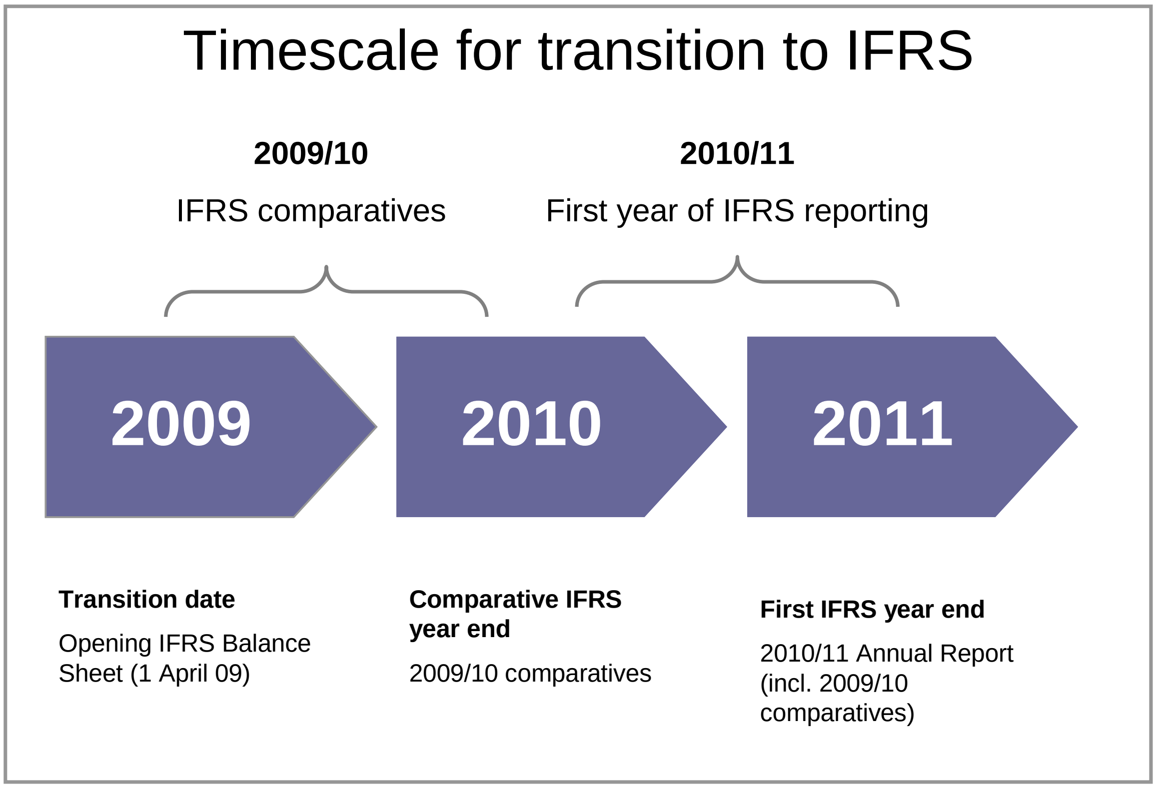
- **Accounting policies:** it will be necessary to disclose within the Statement of Accounts the expected impact of future changes in accounting policies. This is not currently necessary.
- **Prior period errors:** currently, it is only necessary to restate the accounts for the prior period in respect of <u>fundamental</u> errors. The IFRS based Code will require the restatement of the prior period accounts in respect of <u>material</u> errors. This may lead to restatements being required more frequently.
- **Changes to accounting policies:** the Council is currently required to present two balance sheets in its Statement of Accounts - one at the reporting date and one at the previous reporting date. Under IFRS, a third balance sheet (ie: as at the start of the comparative period) will be required to be presented when changes to accounting policies are implemented – this also applies on transition to IFRS.
- **Related party transactions:** the draft Code has different requirements in relation to the disclosure of related party transactions and balances.
- **Group accounts:** the definitions of associates and joint ventures are different under the IFRS-based Code and may cover a wider range of other bodies. Consolidation of jointly controlled entities may be on a different basis.

There are other areas where the accounting treatment required by the IFRS-based Code differs from current practice, but these have not been highlighted within this report as the implications are thought to be minor at this stage.

11. Timescale for convergence

The Chancellor's 2008 budget announced that the annual financial statements of government departments and other entities in the public sector will be prepared using International Financial Reporting Statements (IFRS). Central government, NHS trusts, Primary Care Trusts and NHS foundation trusts begin reporting on an IFRS basis from 2009/10. Local authorities will begin reporting on an IFRS basis in the following year (ie: 2010/11).

The timescale for convergence to IFRS-based accounting for local authorities is illustrated as follows:



12. Timetable and approach to implementation

In central government, departments are required to meet four 'trigger points' set by HM Treasury. These specify the dates by which opening IFRS balance sheet and figures for the comparative year are to be prepared and audited. For local government, no formal 'trigger point' dates have been set. However, CIPFA has issued a bulletin which seeks to address the absence of formal dates through an outline project plan. The project plan represents guidance rather than a formal requirement and is intended to provide a starting point for authorities to develop their own project plans.

On the basis of CIPFA's Bulletin, and the draft Code, an outline project plan of the key actions required to make the transition to IFRS is proposed, as follows:

Timing	Key actions
September – December 2009	Update and revise accounting policies.
	Identify and re-assess all lease arrangements under IFRS prior to re-modelling the accounting entries.
	Identify and collate data required to calculate employee benefit accrual and make the calculations required.
	Review and, if appropriate, re-model the accounting treatment of the Council's related entities in relation to subsidiary accounting, etc.
	Identify any budget implications (if any) arising from the transition to IFRS and compile the 2010/11 budget on an IFRS basis, taking account of any regulations proposed by Government to mitigate the impact on the General Fund.
January – March 2010	Restate the opening balance sheet as at 1 April 2009.
	Draft pro-forma IFRS accounting statements (including notes and accounting policies).
From April 2010	Continue to develop and embed processes and systems for IFRS accounting.
	Implement system and procedural changes (if required).
October – December 2010	Restate 2009/10 accounts under IFRS.
April – June 2011	Produce 2010/11 accounts on IFRS basis.
On-going	Liaison with external auditors, including discussions regarding the timing of IFRS restatement audits, materiality and other issues arising.
	Staff training on IFRS
	Update and report to Audit Committee (including restated figures, progress and findings to date).

As part of the transition to IFRS based accounting it is recommended that, at the relevant stages in the implementation timetable, the Committee reviews:

- the IFRS accounting policies, including significant estimation techniques;
- the restated IFRS opening balance sheet, as at 1 April 2009; and
- the IFRS restated 2009/10 accounts.

In addition, reports will be presented, as appropriate, to keep the Committee appraised regarding progress with implementation of IFRS based accounting.

Borrowing Costs and Capital Grants

1. Introduction

There are two areas where CIPFA/LASAAC has been unable to finalise its proposals, as there is an ongoing debate at national or international level. These relate to borrowing costs and capital grants. The options for addressing both issues are set out below, together with the Council's views on the options.

2. Borrowing costs

CIPFA/LASAAC is seeking views on three options for accounting for borrowing costs. The options relate to whether borrowing costs should be capitalised and, if so, in what circumstances.

Under UK GAAP, borrowing costs incurred as part of the cost of preparing an asset for use, where this necessarily occurs over a substantial period of time, may be capitalised. Borrowing costs are not capitalised where an asset is purchased or made available for use immediately. This approach is currently adopted by the SORP.

Until recently, the UK GAAP treatment was also the treatment followed under IFRS. However, IFRS now requires borrowing costs to be capitalised for qualifying assets.

Within central government, the IFRS-based Financial Reporting Manual (i-FREM) does not permit borrowing costs to be capitalised, but requires them to be immediately expensed.

It would be possible to follow any of these approaches in the IFRS-based Code of Practice, so CIPFA/LASAAC is seeking views on the following options:

- **Option one** – continue to permit the option of capitalising borrowing costs where the asset is produced over a period of time. It should be noted that an accounting policy of capitalising borrowing costs would apply to all qualifying assets of an authority; it would not be permissible to capitalise borrowing costs on selected assets only.
- **Option two** – expense borrowing costs as they are incurred. Under this option, the current option under the SORP that permits borrowing costs to be capitalised would be withdrawn, and authorities would be required to expense all borrowing costs.
- **Option three** – capitalise borrowing costs directly attributable to qualifying assets. Under this option, authorities would be required to identify qualifying assets (ie. those that take a substantial period of time to prepare) and to apportion borrowing costs to the asset.

CIPFA/LASAAC is minded to implement option 2 in the IFRS-based Code. This is the Council's preferred option as well.

This Council, and many other authorities, has not previously capitalised borrowing costs. As a result, options one and two would have no impact on current practice. In comparison, option three would force the Council to capitalise borrowing costs, adding to the administrative burden of accounting for fixed assets.

Options one and two would both maintain the status quo. However, option one is not advocated by the central government i-FREM, whereas option two would ensure consistency between the Code of Practice and the i-FREM, national accounts and an emerging IPSASB conceptual framework.

3. Capital grants

CIPFA/LASAAC is seeking views on two options for accounting for government and non government capital grants/contributions. The two options being considered are:

- **Option one** – defer capital grants and contributions and recognise the deferred income over the useful life of the relevant asset to match depreciation.

- **Option two** – recognise the capital grants / contributions immediately as income once the grant conditions have been met.

Option one is in accordance with current practice but is inconsistent with the IASB Framework for the Preparation and Presentation of Financial Statements, in particular the recognition of a deferred credit when the Council has no liability.

Under option two, capital grants and contributions would be recognised immediately as income in the same period as the specific expense, except to the extent that the grant / contribution has conditions attached to it.

CIPFA/LASAAC is minded to implement option two. This is the option preferred by the Council as well, as it has the following advantages:

- It provides a more accurate position as only liabilities associated with grant conditions not yet met would be reflected in the Balance Sheet.
- Adoption of option two now may pre-empt further changes in accounting practice at a later stage.
- It would mirror the accounting treatment of the awarding bodies.

Neither option above would have an impact on funding/Council Tax; under regulations and statutory guidance government and non government capital grants and contributions that have been charged to the Comprehensive Income and Expenditure statement are not proper income charges to the General Fund.