Audit and Corporate Governance Committee Report

AGENDA ITEM 8

Report of Head of Finance

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To: Audit and Corporate Governance Committee

Date: 14 December 2010

International Financial Reporting Standards (IFRS): update on progress

Purpose of Report

1. This report updates the committee on progress towards complying with International Financial Reporting Standards (IFRS).

Strategic Objectives

2. Sound financial management is central to the strategic objective of managing our business effectively. A full understanding of the transactions involved in the production of the council's annual financial statements and their transfer into a revised format supports the transparency of process whilst conforming to government requirements on accounting practice.

Background

3. Audit and corporate governance committee receives a verbal or written update on progress towards IFRS compliance at every meeting. It was agreed at the September meeting of the committee that a written report on progress would be brought to this meeting.

Work undertaken since September

4. To enable the council to produce IFRS compliant accounts the following tasks must be completed:

- Restatement of the opening balance sheet as at 1 April 2009 to comply with IFRS; and

- Restatement of the 2009/10 financial statements to provide comparators for the 2010/11 accounts.

5. Since the September meeting progress on IFRS has been as follows

   - The restated opening balance sheet has been substantially completed. The remainder of this report discusses this work in detail; and

   - Work has commenced on restating the 2009/10 accounts.

6. In addition, further progress has been made on purchasing a fixed asset accounting system. It is anticipated that the decision on which system to procure will be made by Christmas. Also, external audit have confirmed that they will be auditing both the restated opening balance sheet, and the restated 2009/10 accounts, in early February. Progress on all of these points will be the subject of a written report to the March 2011 meeting of the committee.

Restated opening balance sheet

Background

7. A requirement of first time adoption of IFRS is that the opening balance sheet of the comparative period is restated under IFRS, hence the need to restate the 1 April 2009 balance sheet. The 2010/11 accounts will have three balance sheets, dated 1 April 2009, 31 March 2010 and 31 March 2011, all on an IFRS basis. Restatement of the opening balance sheet is therefore the first major task for IFRS compliance.

8. A copy of the council's audited balance sheet for 2009/10 is attached as appendix A. The opening balances for 2009/10 were restated during the 2009/10 closedown on account of the change in accounting policy for council tax. The restated balances as at 31 March 2009 are now further restated to provide a balance to use as from 1 April 2009 under IFRS accounting policies. This is the starting position to be used to closedown the accounts for 2009/10 in IFRS format and amend the general ledger so that a full IFRS account can be produced for 2010/11.

9. The process of doing this will also act as an opportunity for members and officers to fully understand the changes required so that by June 2011 the new format of the accounts should not present significant difficulties.

Adjustments required by IFRS

10. A copy of the changes required to be made to the balances as at 31 March 2009 to provide opening balances as at 1 April 2009 is attached as appendix B. Explanation of the changes made is provided below.

    COLUMN 1 – INTANGIBLE ASSETS

11. The definition of intangible assets has been extended. The 2009 Statement of Recommended Practice (SORP), included the following statement:

"Internally developed intangible assets should only be capitalised where there is a readily ascertainable market value, which is unlikely to occur in a local authority's single entity financial statements."

12. The new IFRS-based code contains no such restriction. Consequently, expenditure in previous years, for example in relation to in-house computer software development, may need to be accounted for as an intangible asset. However, no significant expenditure has been incurred by the council on computer software development and consequently this balance remains unchanged.

COLUMN 2 – ASSETS HELD FOR SALE

13. Under the old code, surplus assets held for disposal were shown together with fixed assets. Under IFRS, this category is replaced by a new category, assets held for sale, which is shown under current assets. To be classified as an asset held for sale, the asset must conform to the following:

- Management is committed to a plan to sell the asset and an active programme has been initiated to locate a buyer and complete the plan;
- The asset is being actively marketed at a sale price that is reasonable in relation to its current fair value;
- A completed sale is expected within one year from the date of classification (although this period may be extended if any delay is caused by circumstances beyond the entity's control); and
- It is unlikely that there will be any significant changes to the plan or that the plan will be withdrawn.

14. A further change under IFRS means that assets held for sale in the council's balance sheet do not require a depreciation charge to be made because the notion of 'useful life' over which an asset could be depreciated is inapplicable.

15. At the restated balance sheet date, the council had no assets classified as 'surplus assets held for disposal'.

COLUMN 3 – ASSETS UNDER CONSTRUCTION

16. Assets under construction were previously included in 'non operational' assets. The term 'non operational' asset no longer exists as a category within the IFRS accounts. Under IFRS the assets under construction are re-classified as land and buildings, under property, plant and equipment, or as investment property. The assets reclassified as land and buildings are the former surgery, Edinburgh Drive, and Northbourne Centre, Didcot. The Cattle Market, Thame has been re-classified as an investment property.

COLUMN 4 – OTHER NON OPERATIONAL ASSET RECLASSIFICATION

17. All other non operational assets have been reclassified. Assets to the value of £961,000 have been moved to property, plant and equipment. Other non operational assets with minimal value have been re-classified as community assets. This leaves assets with a value of £10.297 million which meet the definition of investment property.

18. To meet the definition of investment property the valuer must ensure that they meet one or the other or both of the following criteria:

- the asset (generally property and/or land) is held to earn rentals
- The asset is held for capital appreciation.

The council's valuer has been requested to confirm this re-categorisation of the assets. Any further changes will require a self-balancing movement between investment property and property, plant and equipment.

COLUMN 5 – INVESTMENT PROPERTY - TREATMENT OF REVALUATIONS

19. All investment properties are required to be held at 'fair value'. The definition of fair value is "the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction". The fair value of investment land and property reflects the market conditions at the end of the reporting period. This means that these assets are required to be reviewed and revalued on an annual basis rather than as a part of the rolling review programme for other council assets.

20. IFRS requires that any gains or losses arising from a change in the fair value of an investment property should be recognised within the profit or loss for the period in which it arises. This means that any revaluation gains which had previously been transferred to a revaluation reserve need to be reversed and treated as a gain to the comprehensive income and expenditure account. Because this gain must not impact on the charge to council tax payers this amount is then reversed out of the general fund and transferred to a non-useable reserve, the capital adjustment account.

21. The council identified two investment assets which had been previously revalued and for which the revaluation amount of £25,000 was held in the revaluation reserve. This amount has been transferred to the capital adjustment account.

COLUMN 6 – REVIEW OF LEASE ARRANGEMENTS

22. The council acts as lessor on a number of investment properties and other land and buildings. To a more limited extent the council is a lessee of items of equipment. The requirements of the IFRS code in respect of lease classification are different to those of the 2009 SORP.

23. Under IFRS, where a lease is a lease of property, the land and buildings elements are considered separately for the purpose of lease classification. Under the previous SORP, both elements would have been considered together. Under IFRS, land has an indefinite economic life. Consequently the land element is normally classified as an operating lease. The property element needs reviewing against set criteria to clarify whether it should be treated as a finance or operating lease.

24. However, investment property leases are treated differently in that separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property. Likewise investment properties are treated by the council (lessor) as operating

leases because in no circumstances would the council let an investment lease whereby the value of the asset was required to be written out of the balance sheet over the period of the lease.

25. For the property elements of leases on assets not classified as investment properties, the criteria used to determine whether the lease is an operating or finance lease are as follows:

    - The lease transfers ownership of the asset to the lessee by the end of the lease term;
    - The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value so as to make it reasonably certain the option will be exercised;
    - The lease term is for the major part of the economic life of the asset;
    - The present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset, and
    - The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

    If one or more of these tests are met then the lease is treated as a finance lease. All other leases are treated as operating leases.

26. These criteria are different from those adopted previously, and how a lease is classified impacts on where income from leases is recognised in the accounts. If, for example, an asset held on the balance sheet as an operating lease was re-classified as being a finance lease, then the asset would be derecognised on the balance sheet and a long-term debtor would be recognised in its place. All subsequent income would be used to write out the debtor rather than as income to the comprehensive income and expenditure account as is currently the case.

27. A full review of the council's operating leases on land and buildings and equipment has been carried out and no re-designation of lease classification has been required.

28. Members will recall that completion of the council's 2009/10 Statement of Accounts included the early adoption of the IFRS Interpretations Committee Update 12 (IFRIC 12), which concerns 'service concession arrangements'. Under the requirements of IFRIC 12, it is possible that the assets of contractors providing services on behalf of councils may need to be brought onto the balance sheets of councils, where those assets are used primarily or solely on activities on behalf of those councils as, in accounting terms, those councils are effectively leasing the assets from the contractor. A review of the council's contracts determined that no assets need to be brought on to the balance sheet.

COLUMN 7 – CAPITAL GRANTS

29. IFRS requires the council to recognise all capital grants and contributions through the comprehensive income and expenditure statement once any conditions have

been met. This is a change to accounting policy and the opening balances must be restated.

30. The council previously had a balance of £152,000 on capital grants unapplied. This was held as a liability in the top part of the balance sheet. This has now been re-classified as a usable reserve in the equity section of the balance sheet since no conditions are attached to its use and there is no possibility of it being reclaimed by the donor.

31. This also has an impact on the practice of maintaining a deferred government grants account. Deferred grants were those grants which had been received previously and which had been spent but which had not been fully allocated to the cost of the asset – instead the grant was allocated to the funding of the asset annually through funding the depreciation cost over the lifetime of the asset. IFRS requires that all grants categorised as deferred grants are immediately allocated to the comprehensive income and expenditure account and reversed out to the capital adjustment account.

32. Developers' contributions remain as liabilities within the accounts because they usually have a condition attached to them – if they are not spent according to the agreement the developer might seek to recover them. Consequently, they are defined as capital grants receipts in advance and the balance sheet account is renamed accordingly.

COLUMN 8 – CASH AND CASH EQUIVALENTS

33. Previously, the only amounts considered to be cash in the balance sheet were balances at the bank and petty cash. IFRS introduces the concept of cash equivalents as a change in accounting policy that requires a restatement of the opening balances.

34. Cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

35. Officers have defined an accounting policy for what they consider to be cash equivalents. This is attached as appendix C. As a result of the adoption of this policy, £9.510 million has been reclassified from short term investments to cash and cash equivalents. The policy adopted will be reviewed and discussed with the external auditor when the restated balance sheet is audited. In the event that the policy needs to be amended, then a further, self-balancing transfer will need to be made between short term investments and cash and cash equivalents.

COLUMN 9 – SHORT TERM COMPENSATED ABSENCES ACCOUNT

36. The term 'short term compensated absences' includes items such as holiday pay and annualised hours accumulated balances. Under IFRS the council must make provision for benefits which have accumulated but are untaken at the balance sheet date. As this cost is not chargeable to the council tax payer, the amount is reversed out of the general fund and transferred to a new reserve, the short-term accumulating compensated absences reserve.

37. For the council, there are two issues, namely untaken annual leave and accrued annualised hours. On the latter, this has proved straightforward to calculate as information on accrued annualised hours is reported to management team every month. However, for annual leave it is more complex, because of the practice at the council of leave years running from the start date of an individual's employment. Whilst annual leave is recorded on the council's human resources system the system is unable to provide simply a figure of untaken annual leave at the end of the accounting period.

38. As a result, and following discussions with the external auditor, it has been decided to undertake sampling of the council's employees to estimate the liability in respect of untaken leave. Ten per cent of the employees was sampled, and the total liability of £202,710 extrapolated from that figure. The sampling and calculations undertaken will be reviewed by the external auditors. In the event of changes to the sampling and calculations being required then a further, self-balancing adjustment will need to be made between the provision and the reserve.

39. It should be noted that, whilst the calculation for the opening restated balance sheet was fairly straightforward, for future years it will become more complex as a result of the increase in shared working with Vale of White Horse District Council. This is also under discussion with the external auditors.

COLUMN 10 – TERMINATION BENEFITS

40. Previously the council had been able to account for termination benefits (e.g. added years on early retirement) over the period in which the payment was due, i.e. over a five year period. With the implementation of IFRS the liability for future year's payments must be recognised in the year in which they are incurred and a defined benefit obligation provision set up to represent the liability.

41. A total of £208,680 was incurred during 2008/09 and transferred to the defined benefit obligation provision. Officers are confirming with colleagues at Oxfordshire County Council that this treatment is correct.

Overall impact of required adjustments

42. Restating the 1 April 2009 accounts into an IFRS format has had the effect of reducing the reported net worth of the council at that date from £103.163 million to £103.087 million.

Revised Balance Sheet format 2009/10 and opening balances

43. A copy of the revised balance sheet in the new IFRS format with opening balances is attached as appendix D. Members will note that the IFRS balance sheet is presented at a much more summary level, with the expectation of greater detail being provided in the notes to the accounts.

Financial Implications

44. The financial implications are as set out in the body of the report.

Legal Implications

45. None

Other Implications

46. There are no human resources, sustainability, equality or diversity implications of this report.

Conclusion

47. This report provides details of the changes required to be made to the opening balances on the balance sheet within the statement of accounts 2009/10 to comply with the requirements of IFRS.

Background Papers

- CIPFA – draft guidance extracts
- International Accounting Standards 16,17,19,20,36,38,40
- International Financial Reporting Interpretations Committee 4,12

Balance sheet as at 31 March 2010

2008/09	2008/09 Restated			2009/10	
£000	£000		£000	£000	*Notes*
525	525	Intangible assets	297		*9.1*
		Tangible fixed assets			
		Operational assets			
25,228	25,228	Land and buildings	25,386		
1,037	1,037	Vehicles, plant, furniture and equipment	871		
404	404	Infrastructure assets	224		
1	1	Community assets	1		
11,257	11,257	Non operational assets	16,674		*9.2*
38,453	**38,453**	**Total fixed assets**		**43,453**	
28,648	28,648	Long term investments		24,243	*20.1*
2,686	2,686	Long term debtors		2,601	*20.2*
69,787	**69,787**	**Total long term assets**		**70,297**	
		Current assets			
11	11	Stock	120		
12,278	6,893	Debtors	7,490		*20.3*
(4,340)	(1,799)	Less bad debt provision	(1,844)		*20.3*
67,028	67,028	Investments	74,778		*20.1*
0	0	Cash in hand	281		
74,977	**72,133**			**80,825**	
		Current liabilities			
(3,584)	(1,069)	Receipts in advance	(2,894)		*20.4*
(701)	(701)	Developers contributions	(2,324)		
(152)	(152)	Capital grants unapplied	(532)		*17*
(7,272)	(6,943)	Creditors	(5,542)		*20.4*
(160)	(160)	Post balance sheet event creditor	0		*23*
(33)	(33)	Cash overdrawn	0		
(11,902)	**(9,058)**			**(11,292)**	
(1)	(1)	Long term borrowing		(0)	
(184)	(184)	Deferred government grants		(15)	*18*
(15)	(15)	Provisions		(15)	*16*
(29,500)	(29,500)	Net pension liability		(48,166)	*21*
103,163	**103,163**	**Net assets**		**91,634**	
(50,273)	(50,273)	Capital adjustment account		(54,664)	*19.2*
(109)	(109)	Financial instrument adjustment account		0	*19.8*
(4,436)	(4,436)	Revaluation reserve		(5,888)	*19.6*
29,500	29,500	Pensions reserve		48,166	*19.5*
(2,749)	(2,749)	Deferred capital receipts reserve		(2,479)	*19.4*
(32,372)	(32,372)	Usable capital receipts reserve		(34,828)	*19.3*
4,730	4,730	Available for sale financial instrument reserve		(628)	*19.7*
(27,479)	(27,479)	Balances - general fund		(27,576)	*19.1*
(19,937)	(19,937)	Earmarked reserves		(13,653)	*19.1*
(38)	0	Balances - collection fund		0	
0	(38)	Collection fund adjustment account		(84)	*Note 4 to CF*
(103,163)	**(103,163)**	**Total equity**		**(91,634)**	