REPORT TO:	**AUDIT SUB COMMITTEE**	**AGENDA ITEM: 11**
DATE OF MEETING:	**16th JUNE 2010**	**CATEGORY: RECOMMENDED**
		OPEN
REPORT FROM:	**DIRECTOR OF CORPORATE SERVICES**	
MEMBERS' CONTACT POINT:	**KEVIN STACKHOUSE (595811)**	**DOC**: u/ks/audit committee/IFRS/update June 2010
SUBJECT:	**IMPLEMENTATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)**	**REF:**
WARD(S) AFFECTED:	**ALL**	**TERMS OF REFERENCE:**

1.0 Recommendations

1.1 That the requirements regarding the implementation of International Financial Reporting Standards are considered.

1.2 That progress to-date and the proposed actions to fully implement International Financial Reporting Standards, as they apply to the Council, are approved.

1.3 That progress against implementation is reported to the Committee on a quarterly basis.

2.0 Purpose of the Report

2.1 Under its terms of reference, the Committee is responsible for monitoring the effective development and operation of Corporate Governance. Under the regulatory framework governing the Council's accounts, the implementation of "International Financial Reporting Standards" (abbreviated to IFRS) is a key governance issue.

2.2 Adopting proper accounting practice is a key measure of good governance; IFRS is a fundamental change in accounting practice. Consequently, it is important that the Council complies and makes the appropriate changes where they apply.

2.3 This report provides awareness for the Committee, including background on IFRS. In addition, it provides an update on the Council's position and the proposed actions to ensure that the Council implements the changes in a timely and correct manner.

Note: CIPFA in the report is the abbreviation for the Chartered Institute of Public Finance and Accountancy. RICS is for the Royal Institute of Chartered Surveyors.

3.0 <u>Detail</u>

Background

3.1 IFRS are accounting standards issued by the International Accounting Standards Board. They are designed to ensure a robust and consistent method of accounting. They have been widely accepted in the corporate/private sector for some years, which acted as a catalyst for common standards.

3.2 It has been recognised in the corporate sector that there is a demand for a single international set of accounting standards. As both business and the financial markets have become more global, one financial language has aided the preparation, comparability and analysis of financial information for corporate entities.

3.3 Latest figures show that around 120 countries worldwide have or are about to implement IFRS.

How they apply in the Public Sector

3.4 Many countries such as the United States and Australia have also implemented IFRS in the public sector. In addition to the benefits highlighted above for the private sector, this ultimately allows a single set of accounts to be drawn up to show the worth and financial standing of the public sector in these countries.

3.5 The public sector in the UK has been slower in adopting IFRS. However, the 2008 National Budget confirmed that IFRS would be implemented across public authorities. The reasons for this were set in the context of the Government's aim to produce "*high value performance data in combination with appropriate financial data*."

3.6 IFRS as adapted for use in the public sector will be used to provide "*benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice*."

Impact on Local Authorities

3.7 Historically, local authorities have used different accounting practice compared to the private sector and indeed, other parts of the public sector. This is due to the different circumstances under which they operate and exist, i.e. public service provision against purely being in business and making a profit.

3.8 However, in recent years local authorities have provided services in different ways, provided services in competition, set up arms length companies, and entered into technical forms of financing such as Private Finance Initiatives. In addition, local authorities own and are responsible for substantial property/asset holdings for which the "true" value or worth has not always been recognised in the accounts.

3.9 Consequently, in recent years, more generally accepted accounting practice that exists in corporate entities has been introduced, such as regular valuation of assets, depreciation accounting and group accounts.

3.10 These general practices have still, in certain circumstances, been adapted for local authorities. In particular, this is to ensure that technical accounting (such as depreciation) does not increase the level of Council Tax.

Timetable

3.11 The full implementation of IFRS will bring the public sector more into line with accounting practice in the private sector. A phased process began in 2007/08 and the Council's accounts reflect some elements of IFRS introduced to-date. In addition, IFRS has already been fully implemented in central government and in the NHS.

3.12 Full implementation for local authorities was 1st April 2010. This means that the first set of fully compliant IFRS accounts will be produced by 30th June 2011.

3.13 However, work will need to be undertaken well before then to meet this deadline, not least restating the current accounts so that a meaningful comparison can be drawn between years.

3.14 When implemented, central government, local government and the health service will then for the first time be accounting on a consistent basis.

The Main Implications

3.15 To a large degree, the changes needed to move from current accounting practice to full IFRS are technical in nature. However, in certain aspects, the implications are wider than this and could affect policy areas.

3.16 For example, requirements to account for accrued holiday leave (as explained later) in the accounts, has been a catalyst for health bodies in the NHS to review the criteria for taking leave. In addition, it is still not clear whether any of the changes could ultimately affect the "bottom line" and spending power of local authorities.

3.17 Furthermore, it is considered that the structure of financial and feeder systems may need to change to meet enhanced reporting requirements.

Statutory Requirement

3.18 The requirements in order to meet IFRS are set out in the 2010/11 Code of Practice on Local Authority Accounting in the U.K. (the Code). This details the accounting requirements and has a legal basis under the Local Government Act of 2003. Effectively, the Council has to comply.

3.19 The Council will need to check that it meets the new standards as set out in the Code and this may prompt several changes to the accounts as they are worked through. The Code is set out in such a way that after each section, a summary is provided of the changes compared to current practice. CIPFA will be producing a practioner's guide on the interpretation and implementation of the Code with examples of how to treat items in the accounts and deal with new disclosure requirements.

3.20 The main technical changes identified in the Code are summarised as follows:

- Treatment of capital grants and contributions
- Structure of financial statements
- A new requirement on segment reporting
- Non-current assets - property, plant and equipment
- Property leases
- Investment properties
- Impairment of assets
- Non-current assets held for sale
- Employee benefits
- Accounting for associates

3.21 It is considered that "Accounting for Associates" is a significant issue for many authorities. This covers how joint ventures/subsidiary companies/PFI's are accounted for and disclosed in the accounts. This leads to a requirement to produce a set of "Group Accounts."

3.22 This is not currently relevant for South Derbyshire as the Council has no such undertakings. A brief explanation of the other changes that will impact on the Council is provided in the following sections.

Grants and Contributions

3.23 Where these are received for capital purposes, they will be recognised as income immediately rather than being deferred and released to the revenue account to match depreciation over the life of the asset that they have paid for.

3.24 Although this is a change in accounting practice, the overall effect on the Council's revenue account will be zero. The actual physical contributions received will be used to finance expenditure in the capital account as it is incurred. The accounting entries to reflect the transactions through revenue will be reversed out later in the accounts.

Financial Statements

3.25 The explanatory foreword (as an introduction to the accounts) will be extended to include more detail of key figures/issues, the rationale behind them, together with greater explanations in less technical terms of the various statements and what they report.

3.26 IFRS introduces a Comprehensive Income and Expenditure Statement that replaces current income and expenditure accounts. A separate Movement in Reserves Statement has also been introduced which consolidates various reserve statements currently required.

3.27 The format of the Balance Sheet and Cash Flow Statement has changed to bring them into line with the corporate sector. The Balance Sheet includes a requirement to report cash and cash equivalents. This will mean that short-term, liquid investments are treated as cash equivalents.

3.28 A significant change relates to a requirement to present a further Balance Sheet when an authority applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

3.29 Other changes include disclosures to explain any estimation of uncertainty that could have a material effect on the carrying value of assets and liabilities, together with significant judgements made in applying accounting policies where they have a significant effect on amounts recognised in financial statements.

3.30 It is anticipated that the new statements will be compiled using the Council's current financial system and no major changes are envisaged to achieve the new requirements. The new disclosures will be taken into account when the accounting policies are set out in the final accounts for 2010/11, where they apply.

Segment Reporting

3.31 The main aim of segment reporting is to provide more information on the income and expenditure of individual services and activities. Disclosures are now required in the notes to the accounts.

3.32 Reportable segments will be based on an authority's internal management reporting, for example, by Department or Directorate, etc. A segment will need to be reported where its expenditure is 10% or more of the gross expenditure within the net cost of services; or its income is 10% or more of the gross income within the net cost of services.

3.33 For each segment, an authority will need to present an analysis of the income and expenditure by cost type (Employees, Transport, etc.). It is anticipated that this information is readily available internally for management purposes at the Council, together with those reported in monitoring statements to the Finance and Management Committee; these can be transposed into the annual accounts.

Property, Plant and Equipment

3.34 Compared to current practice, there is now a greater emphasis to account for the different components of these assets, especially where the component is an asset in its own right or the useful life is substantially different. If the cost of a component is significant in relation to the total cost of the asset, then it should be recognised separately.

3.35 It is still to be confirmed what constitutes a component for local authority assets; further guidance is to be issued later in the year by CIPFA/RICS.

Informal guidance at this stage suggests that no more than 5 possible components will be used.

3.36 In conjunction with the Valuation Office (VO), the Council has reviewed its current asset base and has concluded that most, if not all of the Council's major assets (i.e. its property holdings) will only need to be split between land and buildings as they are currently. However, this will be confirmed later in the year when the VO under take their detailed valuations.

3.37 The Code also makes some technical changes to how assets are derecognised, the basis of residual values and distinguishing between impairment loss and revaluation loss.

Property Leases

3.38 The main change is that the land and buildings elements of the lease have to be classified and accounted for separately and not as a single lease. This is current practice at the Council.

Finance v Operating Leases

3.39 There is a wider issue under IFRS around whether leases are financial or operating. Finance leases are those where the lessee is effectively raising finance to pay for the asset, whereas an operating lease is a rental. Consequently, a finance lease transfers the ownership of the asset to the lessee.

3.40 From an accountancy point of view, the credit liability (effectively a debt) associated with a finance lease has to be shown on the balance sheet of an entity.

3.41 Currently, the Council has outstanding lease agreements in place for wheeled bins and some items of plant and equipment. These are operating leases and no change to accounting practice will be necessary.

3.42 Other leases the Council has around property lettings and agreements are considered to be operating leases. For audit purposes, formal agreement from the VO is being sought.

Investment Property

3.43 The Code requires this to be carried at "fair value." This should reflect what would be paid for the asset in its highest and best use. It is anticipated that this will be equivalent to "market value," the current valuation method. Consequently, the accounting treatment should remain unchanged.

3.44 The Code also introduces a change to how revaluations of investment property are channelled through the accounts, i.e. it will be reflected in the surplus or deficit in the provision of services. However, similar to current practice, it will be reversed out as an adjustment later in accounts so that there is no effect on the "bottom line."

Impairment of Assets

3.45 The Code requires that annual assessments take place as to whether there is any indication that an asset may be impaired. This does not apply where assets are not depreciated or their estimated useful life exceeds 50 years. This will be picked up by the VO in conjunction with the Council as part of the annual valuation work.

3.46 Similar to the treatment of investment properties above, there will be some changes to subsequent accounting entries for losses on the revaluation of assets subject to impairment.

Other Valuation Issues

3.47 A further change is that assets currently valued on a "replacement cost basis" will need to be valued on a "modern equivalent basis." This will affect more specialist assets where the cost of a "modern equivalent" may be significantly different to the cost of the current asset.

3.48 This is not an IFRS issue, but the VO will be using this basis as directed by the RICS. The Council's VO will advise through the valuation process but it is not anticipated that this will impact upon the Council.

Non-current Assets Held for Sale

3.49 The Code lays down strict criteria that need to apply before assets can be classed "as for sale." In summary, the criteria is:

- The asset must be available for immediate sale in its present condition.
- The sale must be highly probable; there is a plan with an identified buyer or market identified.
- The sale should be expected within 1-year.

Employee Benefits

3.50 All benefits need to be accounted for as they are earned by the employee. Clearly, most benefits (mainly salaries and wages) are paid as they are earned during the year. However, some benefits such as paid annual leave may still be outstanding at the year-end.

3.51 The main change is that this will require accruals for items such as outstanding annual leave in the accounts. This could have an effect on budgets of individual services as the outstanding leave will need to be converted into monetary terms and be accounted for in the relevant budget.

3.52 From records kept within the Council, it is considered that the relevant data can be captured to enable a monetary value to be put on employee benefits that will need to be accrued.

Overall

3.53 As previously highlighted the main changes are technical in nature. However, the changes to the accounting treatment of assets could change the reported net worth of the Council and the need to accrue for employee benefits could affect the spending power in individual budgets.

3.54 The correct valuation of assets and how they are accounted for is a key issue in reporting the financial affairs of a local authority. It is a key indicator in the net worth of a council. This can determine borrowing limits and the amount of debt that an authority can afford to manage and sustain. This can also apply to finance leases.

The Council's Position

3.55 As the report highlights, the Council has already undertaken some work to determine the effects of IFRS. Further work is required, especially around asset valuations and leasing to confirm the Council's position, although no significant issues are envisaged.

3.56 Due to potential issues with asset valuation in particular, it is planned to start the annual valuation process earlier and this has been agreed with the VO.

3.57 It is anticipated that the Council's main financial system will be able to meet new reporting requirements and a planned upgrade over the coming year will enhance this further.

3.58 The Council's Asset Management System may require some development work to ensure it is "IFRS compliant" but this will affect all authorities who use this (CIPFA) system. However, there may be a relatively small cost associated with this.

Restating the Accounts

3.59 Once the 2009/10 accounts are audited and published, there is a requirement that they are restated on an IFRS basis. This will be the initial test and should identify any issues ahead of 2010/11. It is planned to undertake this exercise during September/October 2010.

Training and Support

3.60 The Council's External Auditors have been supportive in the Council meeting the requirements of IFRS. They provided a training event for all their client authorities in this region earlier in the year for which there were 3 attendees from the Council, including 2 senior professionals.

3.61 Network support and key literature is available and on-going through CIPFA and RICS via the Council's corporate subscription; further workshops and training events will be attended.

3.62 The Auditors will continue to work with the Council as far as they are able, to ensure that arrangements are in place and in particular, to prepare a transition plan.

4.0 Financial Implications

4.1 None directly, other than the potential issues associated with employee benefits and system development as highlighted in the report.

5.0 Corporate Implications

5.1 None directly.

6.0 Community Implications

6.1 Implementing IFRS in a timely and proper manner demonstrates a high standard of Corporate Governance, which is a key corporate plan action for 2010/11.

7.0 Background Papers

7.1 None