AUDIT COMMITTEE

21 DECEMBER 2010

INTERNATIONAL FINANCIAL REPORTING STANDARDS UPDATE

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Summary

This report advises Members of the progress being made to comply with the requirements of the new International Financial reporting Standards (IFRS).

1. Budget and Policy Framework

1.1 In accordance with the terms of reference, consideration of changes to financial rules, new accounting standards and changes to the reporting framework are matters for this Committee.

2. Background

2.1 All council's accounts are currently prepared using UK Generally Accepted Accounting Practice (UK GAAP). This is converging with International Financial reporting and will eventually disappear. This process has already occurred within the private sector and central government and the NHS were required to be IFRS compliant for 2009/2010. This requirement applies to local authority accounts from 1 April 2010.

2.2 Members of this committee were advised of the potential changes following the introduction of IFRS when considering the Statement of Accounts for 2008/2009 in June 2009 and this will be considered in greater detail later in the report.

2.3 The move to IFRS requires the 2009/2010 Financial Statements to be restated and an opening balance sheet as at 1 April 2009 to be prepared on an IFRS basis. Our external auditors, PKF, plan to review the restated statements in early February 2011. These will form the basis of the IFRS compliant Statement of Accounts for 2010/2011 and future years.

2.4 Although the Chartered Institute of Public Finance and Accountancy (CIPFA) published the Code of Practice on Local Authority Accounting for 2010/2011 (The Code), unhelpfully, detailed guidance notes will not be published until later this month which could introduce further changes to the financial statements.

3. Financial Statements

3.1 The core financial statements currently include the following:

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

In addition, notes to the core financial statements provide further explanation of transactions e.g. Additional Amount Credited To The General Fund In Accordance With Statute and Proper Practice, Movement on Fixed Assets and Movement on Reserves.

3.2 Under IFRS the core financial statements will become:

- Comprehensive Income and Expenditure Account;
- Movement in Reserves Statement;
- Balance Sheet and
- Cash Flow Statement.

3.3 There is a myriad of additional changes required under IFRS including:

- Accounting for PFI and Group Accounts;
- Segment reporting;
- Treatment of ‘embedded leases’;
- Treatment of capital grants and contributions;
- Reclassification of some fixed (now non-current) assets;
- ‘Componentisation’ of non-current assets and
- Disclosure of employment termination payments and other employee benefits.

3.4 The majority of the changes to the format of the accounts, although considerable, are technical in nature and, thankfully, the Council is currently not involved in PFIs or Group Accounts and in this respect officers are confident, subject to the comments in paragraphs 3.6, 3.7 and 6.2, that the restated accounts for 2009/2010 and the Statement of Accounts for 2010/2011 will be produced in accordance with the timetable for audit purposes.

3.5 With effect from 1 April 2010 individual components of non–current assets e.g. land, structure, roofs, plant etc. will need to be separately valued where their value is material or where a significantly shorter useful life and will require replacement on at least one occasion during the life of the asset as a whole. These components will need to be depreciated, revalued and impaired accordingly. There is some inconsistency between local authorities as to what constitutes a component. The Audit Commission has suggested the following components:

- Administrative buildings and schools: boiler and heating systems, lifts, electrical rewiring and flat roofs;
- Housing stock: kitchen and bathrooms, boiler and heating systems and lifts in tower blocks;
- Leisure centres and swimming pools: boiler and filtration systems.

With the agreement of PKF, the Council will undertake future component valuation only for those assets which are deemed to include a material element of plant or specialized equipment e.g. Gun Wharf, swimming pools and the Crematorium.

3.6 By far the biggest challenge imposed by IFRS is incorporating ‘embedded leases’ within the financial statements. In most cases it will be clear when a ‘traditional’ lease exists, however, IFRS defines a lease as an agreement whereby the lessor conveys to the lessee the right to use an asset for an agreed period of time in return for a payment or series of payments. This implies that where the Council employs a contractor to carry out refuse collection, for example, and the vehicles employed by the contractor are used predominantly (but not necessarily exclusively) on our contract, a lease of the vehicles is implied. This means that we have to record the value of these vehicles in our balance sheet, calculate depreciation and all the other accounting entries as if the vehicles belonged to the Council. All of these accounting transactions are retrospective to commencement of the ‘lease.’ This exercise has no impact on the ‘bottom line’ of the Council’s accounts as the notional lease interest charge is offset by a reduction in operating costs within Net Cost of Services in the Comprehensive Income and Expenditure Account.

3.7 Unless already included in contract documentation, contractors are under no obligation to supply the Council with details of vehicles and plant utilised in service delivery. However, in the case of waste and grounds maintenance, officers are working closely with contract staff to obtain the relevant information. Further investigation is ongoing to identify other areas where embedded leases may arise as we must demonstrate to the auditors that all reasonable steps have been taken support or reject the existence of an embedded lease. Should no information be available from a contractor, the Council must estimate the value and estimated life of appropriate vehicles.

4. Accounting Policies

4.1 Part of the transition to IFRS involves review and updating of the Council’s accounting policies. The accounting statements will, be prepared in accordance with the Code which based on approved International Financial Reporting Standards and the Council’s accounting policies will follow these standards wherever practicable.

4.2 Since the inception of Medway the de minimis level for capital expenditure has been £10,000 i.e. only items above this figure would be treated as capital and recorded in the balance sheet together with associated accounting transactions. This figure is considered as too low in view of the IFRS requirement to account for all vehicles and plant included in embedded leases. An increased threshold of £25,000, which is acceptable to the external auditors, is suggested which would considerably reduce the burden of accounting for these relatively small assets. It is, therefore, recommended that the de minimis level for capital expenditure be increased to £25,000.

5. Financial and Legal Implications

5.1 To date there has been no additional cost in adopting IFRS, however, there is a possibility that external support may be required, for example, specialist valuations of property components etc.

5.2 The Code of Practice on Local Authority Accounting in the United Kingdom sets out the proper accounting practices required by section 21 (2) of the Local Government Act 2003. These proper practices apply to Statement of Accounts prepared in accordance with the statutory framework established by the Accounts and Audit Regulations 2003

6. Risk Management

6.1 Failure to implement IFRS will affect on the quality of the 2010/2011 accounts and the audit of these statements possibly leading to a qualified audit opinion.

6.2 Severe budget pressures and consequent reductions in staffing may affect the preparation of the 2010/2011 Statement of Accounts in accordance with IFRS.

7. Recommendation

7.1 Members note the progress to date in implementing IFRS as outlined in Section 3

7.2 Members agree to an increase in the de minimis level for capital expenditure to £25,000.

Background papers
CIPFA Code of Practice on Local authority Accounting in the United Kingdom 2010/11.

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