



# The final countdown

**Countdown to IFRS in local government**

**March 2011**

The Audit Commission's Countdown to IFRS series has reported on the progress of local authorities in implementing International Financial Reporting Standards (IFRS), based on comprehensive surveys of auditors in November 2009 and July 2010.<sup>i</sup> In this final briefing paper in the series, we look at the results of a third auditor survey in January 2011 and key actions that authorities need to consider at this stage of IFRS implementation.

Local authority finance teams will soon be preparing their first full set of IFRS-compliant financial statements to meet the statutory deadline of 30 June 2011. Even those authorities with issues to resolve still have time to implement IFRS successfully, if they take appropriate action. However, they need to act now, as problems that arise later in the final accounts period may lead to added costs for the authority or material errors in draft accounts.

<sup>i</sup> All auditor surveys received a 100 per cent response.

## Key actions

Authorities should:

- complete any key outstanding IFRS implementation tasks, such as restatement work, without further delay;
- integrate any remaining tasks into their accounts closedown timetable;
- leave enough time to prepare the increased number of IFRS disclosures and to resolve any remaining financial reporting issues;
- ensure their accounts closedown timetable is realistic, building in enough time and staff resource to deal with issues that will inevitably arise during the closedown period;
- keep their auditors informed on their progress in resolving IFRS financial reporting issues and seek to agree time in advance to review work as they enter the closedown period;
- continue to discuss progress of IFRS implementation with their audit committees; and
- take steps now to ensure that IFRS knowledge and skills are captured and embedded, to enable good financial reporting in future years.

Auditors will discuss their assessment and the results of the survey with authorities, including the specific actions that individual authorities need to take now to achieve a successful transition to IFRS.

## What next?

We will liaise with key stakeholders, including the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Department for Communities and Local Government (DCLG), on their guidance for authorities on IFRS and financial reporting.

The Audit Commission will continue to provide support to auditors of local authorities on IFRS implementation during the final accounts period 2010/11.

The Audit Commission will report on the outcome of IFRS implementation in our Auditing the Accounts report for 2010/11, to be published in December 2011.

## Background

In 2007, HM Treasury's budget report announced that public sector bodies would adopt IFRS. This was 'to bring benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice'.<sup>i</sup> NHS, probation and central government bodies have already adopted IFRS in their 2009/10 accounts. Local authorities adopted IFRS to a slightly later timetable and will be the

<sup>i</sup> HM Treasury, *Economic and Fiscal Strategy Report and Financial Statement and Budget Report* (March 2007), p.154.

last major part of the public sector to adopt IFRS fully in preparing the 2010/11 accounts.

The Audit Commission (the Commission) has been following the progress of IFRS implementation in local authorities since our first survey of local authority auditors in November 2009. The successful implementation of IFRS is important to the reputation of individual local government bodies and the sector as a whole. It will demonstrate the ability of the sector to manage a major change in financial reporting arrangements. We have published a series of briefings and technical papers to help authorities to meet this challenge.

Our first briefing paper, *Countdown to IFRS* (February 2010), found that authorities needed to take urgent action to assess the impact of, and set up project plans for, IFRS implementation. In our second briefing paper, *Progress on the transition to IFRS* (October 2010), we concluded that:

- overall, most authorities had made progress with IFRS implementation and project planning since the November 2009 survey although some key tasks lay ahead;
- restating the 2009/10 prior-year comparatives and preparing skeleton accounts are essential steps to ensure a smooth transition to IFRS and authorities should give this the necessary priority;
- component accounting, and identifying and reviewing lease arrangements are challenging areas that need careful consideration and planning by authorities;
- authorities should consider their approach to new IFRS disclosures, such as reporting on operating segments, well before preparing their accounts; and
- authorities need to maintain their engagement with auditors, and involve their audit committee or equivalent, throughout IFRS implementation.

We revisited these areas in a survey of all auditors of English local authorities, and police and fire and rescue authorities in January 2011. This briefing paper, the last in this series, summarises findings from the survey.

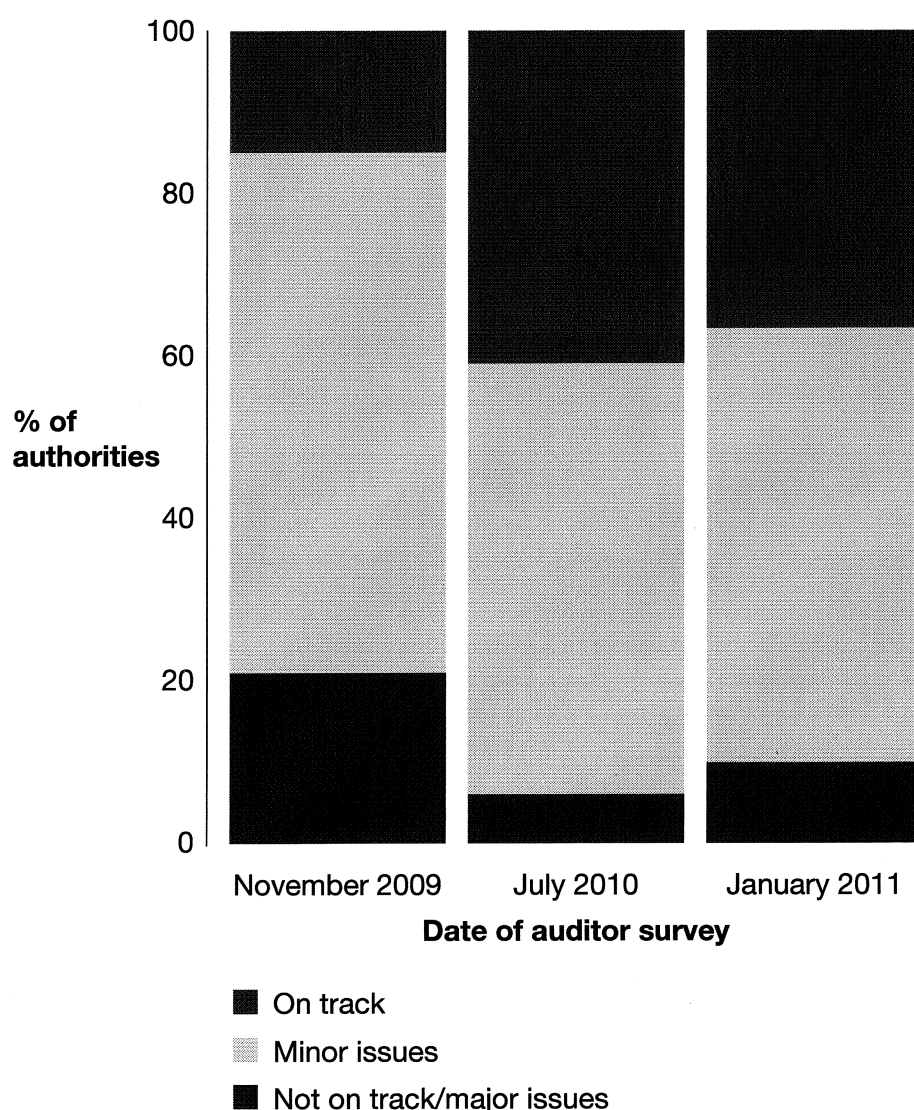
## **Overall assessment of readiness to prepare IFRS-compliant accounts**

In January 2011, as for the two previous auditor surveys on implementation of IFRS in local government, auditors made an overall assessment of each local authority's ability to produce IFRS-compliant accounts for 2010/11.

Auditors used the following ratings:

- Red – not 'on track' or major issues to resolve;
- Amber – minor issues to resolve; or
- Green – 'on track' to produce IFRS compliant accounts.

Figure 1: **Overall assessment of readiness to prepare IFRS-compliant accounts – all auditor surveys**



Source: Audit Commission

Overall, there has been no significant change in the proportion of authorities in each category since July 2010. However, within these overall results, auditors gave 22 per cent of authorities a worse assessment than in July 2010, and 14 per cent a better assessment.

In January 2011, auditors assessed nearly 10 per cent of authorities as 'red' or having major issues to resolve. Auditors assessed authorities as 'red' because:

- restatement work was outstanding;
- there had been general slippage in the implementation timetable;
- there were capacity issues, with a lack of staff to work on IFRS; and
- there were problems with technical issues such as component and lease accounting.

Those authorities assessed as 'amber' had similar issues, although to a lesser degree.

Box 1 shows common characteristics reported by auditors for authorities they assessed as 'green'. These are areas where other authorities could take action.

#### Box 1

Auditors assessed authorities as 'green' (on track), where:

- there were clear and realistic implementation timetables;
- staff had received IFRS training or other technical support was engaged in a timely way; and
- regular discussions were taking place between auditors and officers or audit committees, ensuring that problems were being resolved quickly.

*Source: Audit Commission*

## Key IFRS implementation steps have slipped

In July 2010, 95 per cent of local authorities planned to have completed work on restating 2009/10 prior-year comparatives by 31 December 2010. However, as at January 2011, only 6 per cent of authorities had completed all elements of their work on restatement, and 32 per cent of auditors expressed concerns about the timeliness or quality of this work. Authorities have cited the fact that CIPFA's guidance notes on the application of the IFRS Code were only published in late December 2010 as one reason for delay. However, authorities could have made a start on restatement based on information already available.<sup>i</sup>

Restatement is a key step. While over 90 per cent of authorities were making progress on their restatement work by the end of January 2011, many authorities now plan to complete this work by the end of March. A similar picture emerges on preparing revised accounting policies and skeleton accounts for 2010/11.

A risk remains that timetables at some authorities will slip again, and that those that complete their restatement as part of closedown will identify significant financial reporting issues at a late stage. At those bodies that had done more detailed work on restatement by January 2011, auditors reported that 20 per cent had discovered 'new' financial reporting issues that they had not previously identified (Box 2).

<sup>i</sup> Other sources include the Chartered Institute of Public Finance and Accountancy's (CIPFA) *Code of Practice on Local Authority Accounting 2010/11*, CIPFA's transitional guidance and the accounting standards.

This echoes the experience of the NHS, where 29 per cent of bodies had financial reporting issues to resolve following their restatement work. A key difference is that the Department of Health required NHS bodies to carry out a compulsory restatement exercise around eight months before closedown. This left ample time for NHS bodies to resolve emerging financial reporting issues locally, or highlight that they needed more national guidance. Local authorities have far less leeway in their implementation timetables.

## Box 2

'New' financial reporting issues identified during restatement or skeleton accounts work.

We asked auditors whether any 'new' financial reporting issues had been uncovered during restatement or skeleton accounts work, defining as 'new' any issues that had not previously been identified by the authority as a problem. The issues most commonly identified were:

- complexity of specific leases and of identifying embedded leases;
- accounting for grant income;
- scale and complexity of work for component accounting;
- increased notes and disclosures under IFRS;
- classification of assets held for sale;
- valuation issues; and
- annual leave accruals.

*Source: Audit Commission*

Authorities were most likely to have made progress, or completed their work, on restating opening balances and the comprehensive income and expenditure statement. They were least likely to have finished the notes to the accounts. In NHS bodies, disclosures became a more significant financial reporting issue during the final accounts period, as many bodies had not considered disclosures in enough detail in advance.

Authorities should:

- complete any key outstanding IFRS implementation tasks, such as restatement work, without any further delay;
- integrate any remaining tasks into their accounts closedown timetable; and
- leave enough time to prepare the increased number of IFRS disclosures and to resolve any remaining financial reporting issues.

## Capacity issues have affected IFRS implementation

Capacity issues have caused some of the slippage in timetables. As at January 2011, auditors reported that 15 per cent of authorities had significant capacity problems that were still to be resolved. Single-tier and county councils were more likely to be affected than district councils or police and fire and rescue authorities.

Since the spending review and local government settlement figures have been announced, many local authorities have had to focus resources on other priorities. Some auditors reported that key finance staff were concentrating on revising budgets and medium-term financial plans, which left fewer staff available to work on IFRS implementation. At other authorities, auditors reported that staff lacked relevant experience and technical skills. In addition, many authorities were undergoing internal restructuring, sometimes with direct impact on the finance function. All these factors reduced the capacity to deal with IFRS issues earlier in the 2010/11 financial year, and may continue to affect IFRS implementation in the coming months.

Given the likely financial and capacity constraints, local authorities need to consider how to maintain focus on IFRS implementation and accounts preparation while making the best use of scarce resources.

Local authorities should reflect the increased demand that producing IFRS-compliant accounts will place on finance departments, during an already busy period, in their closedown planning. A failure to do this may lead to unexpected costs. These could include costs of engaging technical experts or contractors, or extra audit costs if there are material errors in draft accounts.

Authorities should:

- ensure their accounts closedown timetable is realistic; and
- build in enough time and staff resources to deal with issues that will inevitably arise during the closedown period.

## Multiple-service authorities may face more difficulties

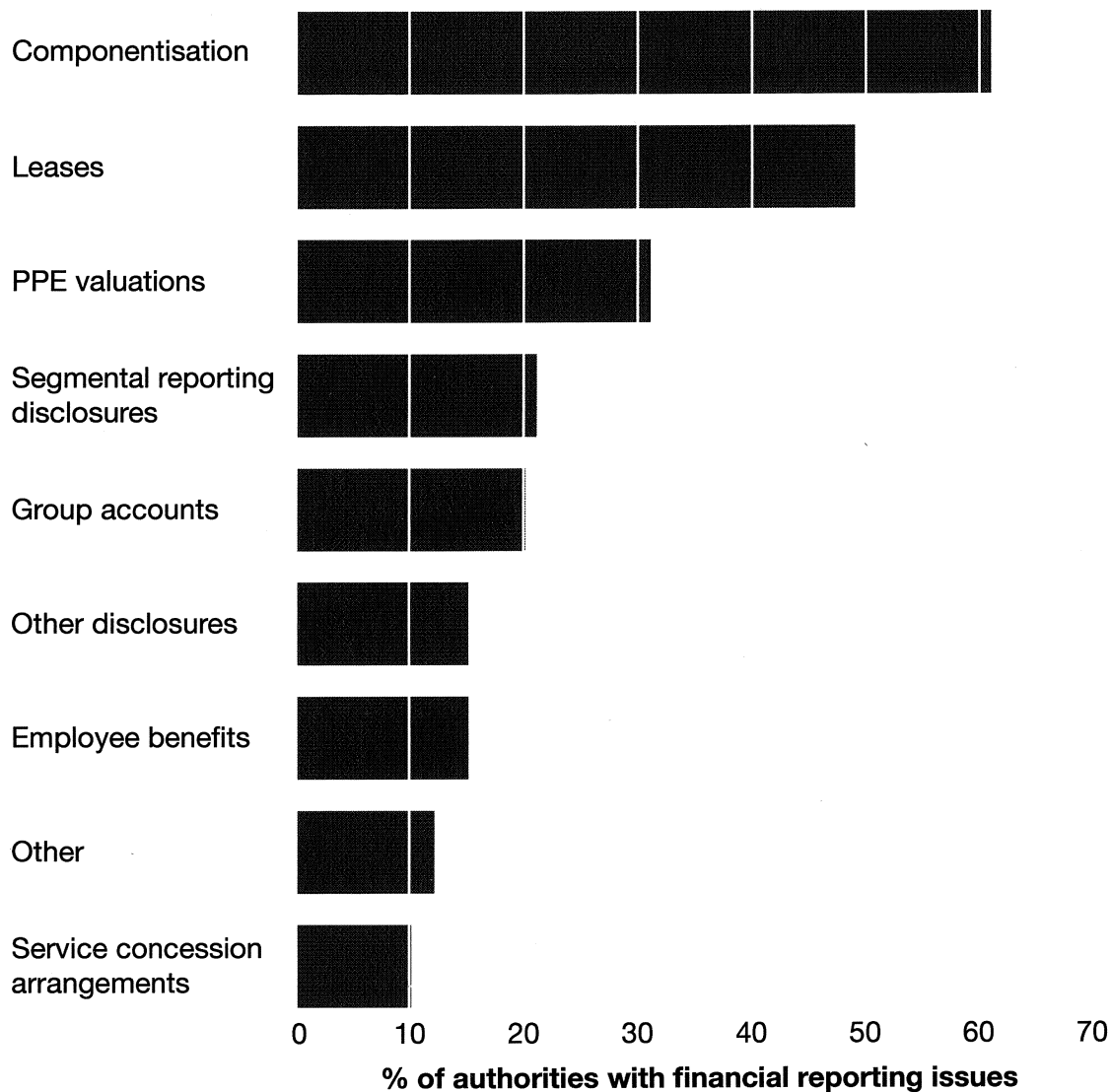
Multiple-service authorities are likely to have more complex transactions, and higher volumes of information to review than single-service authorities. This may add to capacity pressures at larger, multiple-service authorities. These authorities may therefore face more difficulties in implementing IFRS.

The pattern of overall assessments by authority type supports this view. Fire and rescue authorities were most likely to be assessed as 'green', and police authorities had the lowest proportion assessed as 'red'. On the other hand, London boroughs included the highest proportion of 'red' assessments and the lowest proportion of 'green' assessments.

This means that larger, multiple-service authorities should allow more time in their closedown timetables to deal with the likely higher volume of information and complexity of transactions.

## Significant outstanding financial reporting issues

Figure 2: **Outstanding significant or material financial reporting issues at January 2011**



Note: Percentages are based on a total figure of 227 authorities, the number of authorities with outstanding financial reporting issues.

Source: Audit Commission



Auditors signalled that 54 per cent of authorities had significant or material financial reporting issues that remained unresolved as at January 2011. The most common issues related to property, plant and equipment valuations, component accounting and leases. Authorities also had unresolved issues on disclosures and group accounts. More recently, accounting for grant income has emerged as a problematic issue for some authorities. However, it is encouraging that, as at January 2011, auditors felt that 97 per cent of authorities with outstanding financial reporting issues were taking appropriate action to resolve them.

Our analysis of auditors' comments suggests most authorities with financial reporting issues still have time to resolve them. However, they will need to make sure they focus more urgent attention on resolving issues, integrate remaining tasks into their closedown timetable, and continue to liaise regularly with their auditor.

We cover the most common issues briefly in the appendix. For more information on technical financial reporting issues, authorities can also refer to:

- the *Code of Practice on Local Authority Accounting 2010/11* (the Code);
- CIPFA's accompanying *Guidance notes for practitioners 2010/11* (the Code guidance notes);
- The Commission's previous technical briefing papers, which covered accounting for employee benefits, non-current assets, leases and operating segments; and
- CIPFA's Local Authority Accounting Panel (LAAP) forthcoming bulletin, to be published around the end of March 2011.

Authorities should:

- keep their auditors informed on their progress in resolving IFRS financial reporting issues; and
- seek to agree time in advance for auditors to review work as they enter the closedown period.

## Good engagement on IFRS continues

In our last briefing paper, we reported that most audit committees were being kept updated on the progress of IFRS implementation. Auditors report that this engagement on IFRS has continued in most authorities, with 82 per cent of audit committees or the equivalent being updated since our last survey in July 2010.

In those authorities where the timetable for restatement and skeleton accounts work has slipped, it is all the more important that audit committees monitor IFRS implementation during closedown and challenge officers on progress.

Engagement between authorities and auditors has also been maintained, mostly through discussions on IFRS issues with officers or the audit committee. However, only 27 per cent of auditors had been able to review restatement work, usually because of delays in the authority completing this work.

Authorities should:

- continue to discuss progress of IFRS implementation with their audit committees and appointed auditors.

## Authorities need to embed IFRS skills

IFRS should not be seen as a one-off implementation project. Authorities need to embed the technical skills and procedures for gathering information from other departments or external sources to enable good financial reporting in future years. This is particularly important where authorities have used external contractors or temporary staff to support IFRS implementation in the first year.

For example, although *IFRIC 12: Service concession arrangements* was introduced one year earlier in 2009/10, a few authorities had some outstanding issues relating to these arrangements in January 2011 (Figure 2). This was where new projects had become operational in 2010/11.

Component accounting is another area where authorities will need to ensure that skills are embedded within finance and property or estate management departments. As the Code requires component accounting to be applied prospectively to assets that are revalued, enhanced or acquired from 1 April 2010, component accounting is likely to have more impact in future years (see appendix for more detail).

Authorities should:

- take steps now to ensure that IFRS knowledge and skills are captured and embedded, to enable good financial reporting in future years.

## Conclusion

Preparing and publishing audited statutory accounts is the principal way in which local government bodies discharge their accountability for their stewardship of public money to local taxpayers. Although the introduction of IFRS will make this more challenging for authorities in 2010/11, they have a responsibility to provide good quality and timely financial reporting to the public.

Many authorities' IFRS implementation timetables have slipped. This leaves less time to resolve any outstanding financial reporting issues or those that arise later during closedown. It will mean that, for many authorities, the closedown period is likely to be even more difficult and time-pressured than usual. There is also a high risk that draft accounts will contain material errors, leading to more audit queries and delays, and possibly to qualified audit opinions. It may also lead to increased audit costs for authorities.

As at January 2011, auditors reported that 54 per cent of authorities had significant financial reporting issues; however, auditors felt that most of these authorities were taking appropriate action to resolve them. At the time of publication, we cannot comment on whether authorities have now resolved these issues. However, this does suggest that even those authorities that had major issues to resolve at January 2011 can still successfully implement IFRS for 2010/11, if they take appropriate action. This will require authorities to focus more effort on IFRS implementation tasks as part of their accounts closedown. They need to have a realistic appreciation of the work required to prepare IFRS-compliant accounts and assign enough staff resources and contingency time to deal with unexpected issues. They should also continue to liaise regularly with their auditors to discuss emerging issues.

# Appendix 1: significant financial reporting issues

This appendix briefly covers the significant financial reporting issues that remained unresolved at January 2011 (Figure 2). Authorities should refer to the Code, Code guidance notes or further guidance from CIPFA for more information, and discuss issues with their auditors.

## Property, plant and equipment issues

### Valuations

Auditors reported that nearly one-third of those authorities with outstanding financial reporting issues had problems with property, plant and equipment valuations. A key issue has been the need to reclassify assets according to revised categories under IFRS. As the asset valuation basis differs for different categories of asset, authorities may also have to revalue their assets following reclassification. Authorities that had not yet completed these reclassifications had been unable to instruct property valuers in a timely manner. On valuation itself, some authorities were having difficulties determining fair values for investment properties.

Problems were often around the practical issues of getting valuations and instructing valuers, such as:

- problems and timeliness in finance departments getting information from other key departments, such as estates or property management;
- lack of knowledge of accounting implications in property management departments, where they were responsible for instructing valuers;
- setting up new asset registers; and
- the timing of DCLG guidance on valuation of council housing (published January 2011).<sup>i</sup>

Authorities with problems in this area should ensure that finance staff are liaising effectively with estates or property management departments, and that these departments are aware of the impact of IFRS on valuation.

### Component accounting

The accounting standard *IAS 16: Property, plant and equipment* introduced component accounting, the requirement to recognise and depreciate significant parts of assets separately within the accounts. The Code states that local authorities should have applied this prospectively to assets acquired, enhanced, or revalued, from 1 April 2010. The impact on the 2010/11 accounts will vary depending on the extent to which local authorities have acquired, enhanced or revalued assets within the year, and may not be material. However, all authorities should have started work

<sup>i</sup> DCLG, *Stock valuation for resource accounting: Guidance for valuers – 2010 (2011)*

on establishing their accounting policy, and on putting systems in place to enable component accounting. If authorities do not do enough work, there is a risk that they will need to revise accounting policies and restate disclosures in future years to avoid material errors.

Working with departments outside finance is essential. Asset or property management staff should be able to give advice on asset management plans and major replacement programmes. Authorities need to inform valuers about significant components and when these need to be revalued. In some authorities, adopting component accounting has led to setting up new asset registers that can recognise, derecognise and depreciate assets on a component basis.

The main problems identified by auditors in January 2011 were:

- delays in determining the approach or policy for component accounting, such as identifying significant components, suitable de minimis and threshold levels, and the derecognition policy;
- delays in valuation of significant components, because of general delays in valuations (see above);
- determining which components are significant in housing revenue account assets; and
- practical issues with setting up new asset registers that recognise components.

DCLG has published guidance on stock valuation for housing revenue account assets, including guidance to help authorities define their approach to componentisation. This guidance suggests, for example, that authorities may define significant components in council housing as items that in any household are expensive to replace, such as kitchens, central heating boiler systems, bathrooms and roofs.

Our previous papers, *Accounting for non-current assets* and *Progress on the transition to IFRS*, have discussed component accounting in more detail.

## Leases

Auditors indicated that many authorities were still having problems in applying *IAS 17: Leases* and *IFRIC 4: Determining whether an arrangement contains a lease*. These problems were mainly around:

- reviewing leases or getting enough information to enable review;
- classifying leases; and
- identifying embedded leases.

Larger authorities in particular need to ensure they have set aside enough time to gather and review all the relevant information on their lease arrangements. Our previous technical paper, *Identifying and accounting for leases*, discussed these issues in more detail.

## Disclosures

Twenty-one per cent of authorities with outstanding issues had problems with making segmental reporting disclosures, and 15 per cent had problems with other disclosures. Our previous technical paper, *Reporting on operating segments*, explored in detail the principles to follow in identifying operating segments and making disclosures.

Some authorities had outstanding issues because they had not yet started to consider how to identify operating segments. Other authorities were considering various options for reporting operating segments along internal reporting lines, for example reporting according to member-led themes, corporate priorities or portfolios.

One issue affecting some authorities was how to report on and disclose comparative figures for operating segments where internal reporting had changed during 2010/11. This could happen as the result of internal restructuring or changes in members and portfolios following elections.

In resolving the above issues, authorities should keep in mind the core principle of *IFRS 8: Operating segments*. Segmental reporting should enable users of financial statements to understand the nature and financial effects of an entity's business activities and the economic environments it works in. Although segmental reporting lines will differ between authorities, they need to be able to show that their approach meets this core principle and the other requirements of the standard.

Other specific disclosure issues related to IAS 19 pension liability disclosures, and investment properties.

## Accounting for grants

One issue that auditors have raised more recently, and that featured among the 'other' outstanding financial reporting issues, is the treatment of grants. The Code requires authorities to recognise revenue and capital grants and contributions, including donated assets, when there is reasonable assurance that the:

- authority will comply with the conditions attached to them; and
- grants or contributions will be received.

Authorities should initially recognise grants and contributions as receipts in advance or creditors, if conditions have not been met. When conditions are met, authorities should recognise grants immediately as income, rather than matching income to related expenditure.

Auditors reported that a few authorities had some outstanding problems in this area, including:

- having many grants to review;

- having inadequate information on the conditions attached to grants, particularly older grants; and
- considering whether and when conditions have been met.

The Code guidance notes give more examples of conditions and restrictions relating to grants and how these would affect grant income recognition. We understand CIPFA's forthcoming LAAP bulletin will include more clarification.

## Group accounts

Under the Code, authorities with interests in subsidiaries, associates or certain jointly controlled entities must prepare group accounts as well as single-entity financial statements, unless the authority's interest is considered not to be material.

Changes in definitions of 'control' over entities under IFRS may increase the number of bodies within group boundaries, and the number of authorities that need to prepare group accounts. Briefly, authorities need to:

- identify arrangements in which they have an interest;
- determine whether these arrangements give them an 'ability to control' an entity and should therefore be included in group accounts;
- align accounting policies for entities within the group; and
- identify consolidation adjustments, such as removing intragroup transactions.

Our January 2011 survey shows some authorities are still assessing arrangements to determine whether group accounts will be required. Other authorities that had identified entities within their group boundaries were having problems in getting relevant information from them to allow consolidation and alignment of policies.

Authorities identifying entities that they need to include in group accounts should consider the practical implications of consolidation. These would include scheduling a consolidation timetable within the closedown process, and possibly converting UK GAAP-based financial statements of some entities to IFRS. It is essential that there are good communications with group entities and means of getting information quickly.

## Employee benefits

A smaller number of authorities had outstanding issues relating to employee benefits. These were mainly around the requirement to account for staff leave entitlements not taken by year-end as accruals, including arrangements such as time off in lieu and flexitime. This has been particularly difficult for authorities with paper-based annual leave systems, with varying dates for the start of employees' leave years, and for those authorities that have to include teachers' leave accruals. We have discussed employee benefits and methods for collecting and sampling data in detail in our previous technical paper, *Accounting for employee benefits*.



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