

HAMPSHIRE COUNTY COUNCIL**Report**

Committee/Panel:	Audit Committee
Date:	25 March 2010
Title:	International Financial Reporting Standards Implementation – Project Update
Reference:	1393
Report From:	County Treasurer

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1. Summary

1.1. This report provides an update to the Audit Committee following the report on 1 September 2009 regarding the required implementation of International Financial Reporting Standards (IFRS) for the financial year 2010/11. It sets out the developments that have taken place in terms of standards and guidance as well as outlining progress made to date with the project. Appendix C summarises the main issues associated with IFRS implementation.

2. Contextual Information

- 2.1. Following the end of the consultation period on the draft Code of Practice in September 2009, the final Code of Practice was issued jointly by the Chartered Institute for Public Finance and Accountancy (CIPFA) and the Local Authorities (Scotland) accounts advisory committee (LASAAC) towards the end of December 2009. Coming into effect for the financial year 2010/11, this sets out the requirements for presentation of local government financial information in accordance with IFRS. This represents a change from previous local government accounting which has been in line with UK accounting practices as detailed in the Statement of Recommended Practice (SORP) which preceded the Code. The SORP will be the relevant guidance for producing the 2009/10 Statement of Accounts for the final time. The changes between the SORP and Code require a significant project in order to assess accounting information as well as systems, processes and management information.
- 2.2. The change to IFRS is not simply a finance issue as it has wider implications for the organisation. It encompasses many of the practices of the Council from procurement to staffing. The project is being co-ordinated from within

County Treasurer's Department but requires buy in and considerable amounts of work from other departments of the Council.

- 2.3. If the Council were to fail to meet the requirements of the IFRS Code in producing the Statement of Accounts for 2010/11 this could lead to a qualified opinion on the accounts from the Audit Commission. This would impact on the reputation of the Council and would have a negative effect on the Use of Resources assessment which feeds into the Comprehensive Area Assessment (CAA) score.
- 2.4. The County Council is well placed to meet the requirements. In November 2009 the Audit Commission carried out a survey of local government authorities to determine the progress on the implementation of IFRS. This was against a backdrop of deadlines set out in LAAP Bulletin 80 which had presumed that the final Code of Practice and related guidance would be issued well in advance of the actual publication date. The Audit Commission evaluated the progress of authorities based on a traffic light system and the Council achieved a green light in this evaluation.
- 2.5. As an outcome from the survey the Audit Commission has written a report on their findings. This states that only one in seven authorities was assessed as being on track with the project. Therefore it was a particular achievement that the Council was given a green light indicator. In addition, weaknesses were found in authorities' project plans as very few of these included the details the Audit Commission expected to find. Feedback received directly from Audit Commission staff in particular praised the Council's detailed project plan against which the project is being monitored.

3. The Code of Practice

- 3.1. The final Code of Practice for local government accounting in 2010/11 included further information that had not been provided in the draft and had been added following the consultation process with local government.

Government and Non-Government Grants and Contributions

- 3.2. The final Code outlines a change in treatment of Government and Non-Government Grants and Contribution for capital purposes. Currently, once capital grants are received and applied they are held on the balance sheet as a liability called 'Deferred Grants and Contributions'. These are then written down over the life of the relevant assets, the income gradually being released to match the depreciation charge on the assets. The new treatment under IFRS will be to recognise these grants as income in the Income and Expenditure Statement in the year in which they are applied and all conditions attached to them are met. There will no longer be a liability held on the balance sheet, except where grants remain unapplied or conditions have not yet been met. The motivation behind this change is to recognise that these grants and contributions are not in fact liabilities as they are currently presented. Instead they will be presented as income received in order to fund activities.

- 3.3. This change will reduce the balance of liabilities over current assets and to conversely increase income within the year. On the 2008/09 balance sheet the total outstanding balance of the Deferred Grants and Contributions liability, after the amortisation in the year, was just under £475 million. The effect of this change in restating the 2008/09 balance sheet will be to transfer the £475 million from liabilities in the balance sheet to the Capital Adjustment Account. The overall effect will be to increase the total net worth shown in the balance sheet. In future years the effect of this change will be to show grants and contributions as income in the Comprehensive Income and Expenditure Statement, which will then be reversed out through the Statement on Movement in Reserves to the Capital Adjustment Account. There will be a further impact when restating the 2009/10 balance sheet totalling the amount of capital grants and contributions received and applied in the year.

Borrowing Costs

- 3.4. In line with the move to IFRS the Code will allow capitalisation of borrowing costs in some circumstances, a mechanism which has not previously been permitted. Authorities will be able to capitalise interest and other borrowing costs which are directly attributable to the acquisition, construction or production of qualifying assets. Qualifying assets would be those which necessarily take a substantial period of time to get ready for their intended use or sale.
- 3.5. It will not be mandatory to capitalise borrowing costs and each authority must determine its own accounting policy in that respect. Where an authority chooses to adopt an accounting policy of capitalising borrowing costs for a certain type of project it must then apply this accounting policy consistently to all projects meeting the same criteria.
- 3.6. This mechanism is designed to allow organisations to capitalise the total cost of major projects, particularly where projects have a long gestation period and are associated with a future income stream, such as regeneration projects. It is not expected that Hampshire County Council would want to capitalise borrowing costs and the intention is to develop an accounting policy to this effect.

Introduction of Regulations

- 3.7. The Department for Communities and Local Government (DCLG) began consulting in November 2009 on changes to regulations for local government capital finance. This included proposals for mechanisms to negate some of the impacts of transition to IFRS accounting. The Council has responded to this consultation which ended in January 2010. The summary of responses to the consultation including any expected amendments to proposals was published in February 2010.
- 3.8. As a result of the transition to IFRS accounting it is quite likely that leases which were previously classified as operating leases will now be classified as finance leases. Where leases are granted to other bodies for use of Council assets, income will have been treated as revenue income and

credited ultimately to the General Fund. If reclassified as finance leases under IFRS this income would be treated as capital receipts and this change could potentially impact on the General Fund balance. The proposed regulation is to allow all income from leases in existence at 31 March 2010 to continue to be treated in the existing way. This means that although we may have to reclassify some leases and effectively dispose of the assets, the balance of funds available for revenue activities will not be affected.

- 3.9. As reported in September the change to IFRS accounting requires an accrual in the accounts for accumulating employee benefits. This covers annual leave and flexi-leave which is carried forward at year end. This could impact upon the General Fund balance in the initial year of transition, for the restatement of the 2008/09 balance sheet. It is unlikely that the impact of this accrual would change materially year on year, and so there would be no further material impact. However the consultation on capital finance has proposed the creation of an Employee Benefits Adjustment Account to avoid it having any revenue impact at all. The entry of an accrued liability in the Balance Sheet would therefore be offset by an entry in the Employee Benefits Adjustment Account.

4. Early transition elements

- 4.1. Some elements of IFRS accounting have been introduced earlier than the overall 2010/11 target in order to smooth the transition and tackle some of the bigger issues early on.
- 4.2. In the 2007/08 SORP the requirements regarding the presentation of Financial Instruments in the accounts were changed to be in line with possibly the most complex IFRS. Financial Instruments are any contracts which give rise to a financial asset of one organisation and a financial liability or equity instrument of another. This covers debtors, prepayments and investments. For the 2007/08 Statement of Accounts the Council successfully implemented the new requirements with regard to the presentation of these items. Recent feedback from the Audit Commission has suggested that many authorities experienced difficulties with this transition. It can therefore be seen as a success story for the Council that our external auditors were satisfied with our approach and outcome.
- 4.3. As outlined in the report to the Audit Committee on 1 September, the final SORP of 2009/10 has been used to progress early transition of international standards in accounting for Service Concessions, including contracts of service and infrastructure delivery such as Private Finance Initiatives (PFIs) and other public-private partnerships (PPPs). These contracts, where they meet specific criteria, are to be brought 'on balance sheet' with the annual charges being split between service provision and financing of Council assets. As such the Statement of Accounts will include an operating charge and an interest charge on the Income and Expenditure Statement. The Balance Sheet will show the value of the assets provided and a corresponding liability which will equate to the total outstanding principal payments for those assets.

- 4.4. Although the Council currently has no PFIs in place, it is shortly to commence the new Street Lighting PFI contract. In light of this, significant work has been undertaken in anticipation of these requirements to ensure that information is obtained from the financial model for the Street Lighting PFI in order to calculate the entries necessary for the 2010/11 accounts. As this is a complex accounting issue, the County Council has commissioned some external accounting advice from the financial advisers who worked on the project.
- 4.5. In addition, there has been significant work to evaluate the status of the long standing Hampshire Waste Disposal Contract, a joint contract with Veolia between Hampshire County Council, Southampton City Council and Portsmouth City Council. The nature of this contract and its relationship with the three authorities are such that application of the relevant international standard is not clear cut. In addition, the accounting adjustments will have to be backdated to the start of the contract. To ensure the County Council's approach for this contract is robust, some external accounting advice has been commissioned.

5. Progress for 2010/11 Statement of Accounts

Statement Format

- 5.1. IFRS require some changes to the presentation of the main statements including the introduction of a new statement on the movement of reserves to replace the current statement of movement on the general fund balance and the statement of total recognised gains and losses (STRGL). A set of skeleton accounts in the new format has been prepared and is ready to use for the restatement of the 2008/09 balance sheet and the preparation for restating the Statement of Accounts for 2009/10. In addition, under IFRS, authorities will be required to produce segmental reporting information in the accounts which shows the income and expenditure across different segments of the organisation. It is planned to use the management information structure as currently reported to Members. However, it needs to be recognised that the basis for reporting the income and expenditure account is different to the basis for setting budgets for council tax setting and so there will not be an exact match between segmental reporting and internal management accounts reporting.

Notes to the Accounts

- 5.2. Under IFRS the notes to the accounts have changed and become slightly more complex. An initial piece of work has been done to compare the IFRS notes with the SORP 2009 notes in order to establish differences. Further work on this area is ongoing in order to determine how some of the new information will be gathered. It is expected that the comparative information for 2009/10 will be largely gathered during or around the forthcoming final accounts process.

Employee Benefits

- 5.3. A survey of non-teaching staff across the Council has been carried out to determine the average level of annual leave and flexi-leave carried forward at the end of March 2009 in order to restate the 2008/09 balance sheet. Taking into account different working practices across the authority, there is a low average level of leave carried forward for non-teaching staff with an estimated value of just under £2m which represents 0.61% of the Council's total pay costs for non-teaching staff.
- 5.4. For teaching staff the current calculation has been based on guidance issued in December 2008 This has resulted in an estimated accrual of £30m representing approximately 7% of the total pay costs for teaching staff. However there remains some debate about the interpretation of the teachers' contract and the current estimate may need to be revised, once the CIPFA guidance has been finalised.
- 5.5. Whilst the accrual for teaching staff benefits represents a material amount it is the opinion of the authority that the value of non-teaching staff benefits is not significant enough to warrant an entry into the accounts. However it is likely that the Council will be required to continue to conduct an annual review of this figure to ensure that it does not reach a material level.
- 5.6. As noted earlier in this report, any accrual in the Balance Sheet for employee benefits will not impact upon the General Fund and will instead be offset by an Employee Benefits Adjustment Account.

Leases

- 5.7. Significant work has been carried out to identify all the material existing lease arrangements of the Council. A large proportion of these have been assessed against the indicative criteria included in the Code to determine whether they are operating or finance leases. The overarching principle against which to assess the leases is where the risks and rewards of the assets lie, regardless of the legal arrangements of a contract.
- 5.8. The majority of leases have been assessed as operating leases or as immaterial. A shortlist of around 120 lease arrangements is being further analysed to see whether they meet the criteria for finance leases. This work requires in depth investigation into the lease agreements, the use of the assets and the values of those assets.
- 5.9. To complete the leasing work, calculations will then be done to determine the entries in the accounts for those leases which are reclassified as finance leases. This work will be incorporated within the restated balance sheet for 2008/09 and will feed into the restatement of the 2009/10 accounts.
- 5.10. Consideration has also been given to whether the County has other contract arrangements which contain embedded leases. This is where a contract confers the power to control specific assets. Having investigated the major contracts of the Council it has been concluded that there are currently no embedded leases. However, this work will be ongoing to continue to assess new contracts.

Investment Property and Assets Held for Sale

- 5.11. Work is currently being completed by the Estates Practice to assess whether any of the property held at the end of 2008/09 met the criteria in the new IFRS Code for classification of Investment Property or Assets Held for Sale. Once completed there will be work required to determine to relevant entries to restate the 2008/09 balance sheet for any assets meeting these criteria.

Systems

- 5.12. Some small system changes have been identified for SAP and discussions have taken place with Corporate Solutions and SAP representatives on how to implement these. Testing and developments in this area will be taking place shortly. It does not appear that SAP will be able to carry out or automate the necessary calculations for the transactions to deal with finance leases. It is expected that this work will be completed manually.

6. Future work

- 6.1. Work is now ongoing to resolve outstanding issues and restate the 2008/09 balance sheet in advance of the final accounts process for 2009/10. The 2009/10 Statement of Accounts will be prepared in accordance with the final SORP 2009. During this process the relevant information will be collected in order to restate these accounts in line with IFRS requirements to present comparative figures in the 2010/11 Statement of Accounts.
- 6.2. Overall this ongoing work will be completed in accordance with the project plan, drawing on external advice where necessary and keeping the external auditor informed.

7. Conclusion or Recommendation

- 7.1. That the Audit Committee note the progress made and the work still required for the successful implementation of the IFRS Code of Practice.
- 7.2. That a further report on IFRS implementation be considered by the Audit Committee in September 2010.

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

Hampshire safer and more secure for all:	no
Corporate Improvement plan link number (if appropriate):	
Maximising well-being:	no
Corporate Improvement plan link number (if appropriate):	
Enhancing our quality of place:	no
Corporate Improvement plan link number (if appropriate):	

Other Significant Links

Links to previous Member decisions:		
<u>Title</u> Implementing International Financial Reporting Standards	<u>Reference</u> 918	<u>Date</u> 1 September 2009
Direct links to specific legislation or Government Directives		
<u>Title</u> The Code of Practice on Local Authority Accounting in the UK 2010/11 (Based on International Financial Reporting Standards)		<u>Date</u> December 2009

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

IMPACT ASSESSMENTS:

1. Equalities Impact Assessment:

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

- 2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific proposals.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific proposals affecting adaptation to climate change.

Implementation of International Financial Reporting Standards (IFRS) in local government – Summary of the main issues

- Local authority accounts will in future be prepared in accordance with international rather than UK accounting standards.
- Due to be implemented from 2010/11's accounts but will require restatement of the income and expenditure account for 2009/10 and of the balance sheets as at 1 April 2009 and 31 March 2010.
- Local authorities will be required to produce their accounts in accordance with an IFRS Code of Practice, which was issued in December 2009.
- The IFRS code will result in some changes to the format and content of the Income and Expenditure Account, the Statement of Movement on the General Fund Balance, and the Statement of Total Recognised Gains and Losses. Regulations have been introduced designed to ensure that implementation of IFRS has no material effect on the General Fund balance and thus on council tax.
- The main impact of IFRS is on the balance sheet and is designed to ensure that the balance sheet captures all material assets and liabilities and only those that are true assets or liabilities. There is also more emphasis on enabling the reader to understand the basis on which asset and liabilities are recorded or disclosed.
- One of the main changes to the treatment of assets and liabilities is being introduced a year early in 2009/10 to coincide with the requirements of Whole of Government Accounts (WGA). Private Finance Initiative and related contracts will be accounted for in accordance with the relevant international standard (IFRIC 12) from 2009/10. This is likely to result in assets and liabilities being recorded on local authority balance sheets which were not under UK accounting standards.