INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Report By: ACTING HEAD OF FINANCIAL SERVICES

Wards Affected

None affected.

Purpose

1. To report to the Audit and Corporate Governance Committee on the introduction of International Financial Reporting Standards (IFRS) to local authority accounts.

Financial Implications

2. No financial implications.

RECOMMENDATION

THAT the Audit and Corporate Governance Committee note the report.

Reasons

3. To inform the Audit and Corporate Governance Committee about the changes required by the introduction of IFRS.

Considerations

4. The March 2007 Budget Report announced that International Financial Reporting Standards (IFRS) would be introduced into the public sector. The reason for the change was to bring consistency and comparability between financial reporting in the global economy and to follow private sector best practice. Listed companies in the European Union have had to produce IFRS compliant consolidated accounts since 2005.

Timetable

5. The first year of implementation for central government and the NHS is 2009/10. For local government full implementation is 2010/11, but comparative figures are required for 2009/10, with a restated balance sheet as at 1st April 2009. The changes for Private Finance Initiative (PFI) may come in earlier and the Whole of Government Accounts will be prepared on an IFRS basis for 2009/10. An IFRS code for local government is expected to be published Autumn 2009.

Main Issues

6. There is no specific guidance for local authority accounts at this stage, but the main issues can be identified from the standards and progress in central government.

Further information on the subject of this report is available from Heather Foster,
Acting Head of Financial Services on 01432 383173

Some of the more significant changes introduced by IFRS are as follows:

a. Presentation and disclosures
b. Property, Plant, Equipment
c. Assets held for sale
d. Investment Properties
e. Intangible assets
f. PFI contracts
g. Leases
h. Employee Benefits

Presentation and Disclosures

7. When companies introduced IFRS the average increase in the length of financial statements was 56%. For the first set of IFRS accounts there are extensive disclosures including reconciliations from previous UK Generally Accepted Accounting Practice (GAAP) to an IFRS basis. IFRS requires full retrospective adoption of most standards, with some optional exemptions.

8. The statements required by IFRS are different to the current requirements, and are:

   a. Statement of Financial Performance
   b. Statement of Financial Position
   c. Statement of Changes in Taxpayers' Equity
   d. Cash Flow Statement

9. There are also different requirements for the breakdown of business operations (segmental reporting) to be shown in the published accounts. Currently the first section of the Income and Expenditure Account is required to show segmental reporting in the form of the Best Value Accounting Code of Practice (BVACOP), or this can be shown as a note if an alternative analysis is used. In Herefordshire Council's accounts the spend is broken down by Directorate with the Best Value analysis provided as a note. Under IFRS operating segments relate to business activities as regularly reviewed by the organisation. There are quantitative thresholds to determine how the split should be made. It is possible that this may be over-ridden for local authorities in order to preserve comparability by retaining the BVACOP format.

10. The analysis of the balance sheet will be different under IFRS, with assets and liabilities split between 'current' and non-current'. The classification of assets will change with most of the tangible assets described as 'Property, Plant and Equipment'. Other categories include 'Investment property', 'Intangible assets', and 'Assets held for Sale'.

11. The Statement of Changes in Taxpayers' Equity will replace the Statement of Total Recognised Gains and Losses and the Statement of Movement on the General Fund Balance.

12. The cash flow statement is similar but includes cash equivalents, not just cash. In other words it will now include short term investments.

Property, Plant, Equipment

13. The rules around recognition of fixed assets remain the same i.e. measured at cost, including directly attributable costs. For subsequent measurement the valuation basis for assets will mainly be fair value, with depreciated replacement cost as a last resort. Fair value is determined by professional valuers based on market evidence. Under current arrangements valuations take account of the 'existing use' of the asset.

14. Components of assets will need to be valued and depreciated separately. Also where parts of assets are replaced e.g. a roof, the existing value of the roof would have to be written off before adding the costs of the new roof. Material components need to be identified and separated at the date of transition to IFRS.

15. The current requirement for revaluation is intervals of not more than 5 years, whereas under IFRS there are options for the programme of revaluations.

16. Organisations have to assess at the end of each balance sheet date whether there is any indication that an asset may be impaired. There are no specific requirements under IFRS to carry out impairment reviews at the end of each reporting period where there is no depreciation charge or the useful life exceeds 50 years (as currently required). There are also some technical changes around the treatment of impairments.

Assets Held for Sale

17. Assets 'held for sale' will have to be shown separately in the balance sheet. In order to be classified as 'held for sale' assets have to meet certain conditions:

    a. Available for immediate sale in its present condition.
    b. The sale must be probable

18. These assets are not depreciated and any reduction in value is treated as an impairment loss.

19. At the point of transfer to IFRS all assets meeting the definition of 'held for sale' will have to reclassified and measured as such.

Infrastructure Assets

20. There is also a possible change to the valuation of infrastructure assets for local government, which although not directly the result of IFRS, is being reviewed at the same time. Under the current rules they are valued at depreciated historic cost, but changes to this are under discussion.

Investment Properties

21. The definition of investment properties will be narrower leading to a reduced number of assets defined as investment properties. Investment property will be defined as one used 'solely to generate rental income or capital appreciation' and will be carried at fair value. They will be shown as a separate line on the balance sheet.

Intangible Assets

22. A wider range of assets may be recognised as intangible under IFRS. Some local authorities may be able to recognise internally generated intangible assets such as

computer software and web sites. Also development expenditure may be capitalised if its meets certain criteria.

23. When the opening IFRS balance sheet is prepared previous development work will need to be reviewed to assess whether it should have been capitalised. Also any software included in fixed assets will have to be separated out and re-classified as intangible. All intangible assets will have to be recognised and valued and assessed as having a finite or infinite useful life.

PFI contracts

24. The new standard for accounting for PFIs is likely to mean that more PFI contracts will be ‘on balance sheet’. The determining factors will be about control and residual interest, rather than risks and rewards of ownership.

25. The accounting changes for PFI contracts going on-balance sheet are extremely technical and there may also be considerable difficulty in extracting the required information from the contract. Once such area is splitting the annual charge that is part of most PFI contracts into component parts and determining the interest rate implicit in the lease. The Council has two PFI contracts, Waste Disposal and Whitecross School, which will have to be reviewed and revalued.

26. The Chartered Institute of Public Finance and Accounting (CIPFA) is likely to introduce the PFI changes a year earlier, in 2009/10.

Leases

27. IFRS requires leases to be classified as either finance or operating leases, as is currently required, but the criteria for doing this is different under the new and old standards. Currently there is a quantitative test of whether a lease is a finance lease (measuring the value of 90% of discounted payments) which will be replaced by a number of tests. This may mean more leases being classified as finance leases, which have different and more complicated accounting arrangements. Accounting for finance leases requires the recognition of an asset and liability on the balance sheet at fair value or, if lower, the present value of the minimum lease payments. Lease payments have to be apportioned between the finance charge and the reduction of the outstanding liability. The asset is depreciated over the shorter of the length of the lease and its useful life. The council’s leases will have to be reviewed, with evidence held for how the lease has been classified.

28. In addition, leases including both land and buildings will have to be split between the two elements. The land is likely to be an operating lease but the building could be either finance or operating.

Employee Benefits

29. One particularly challenging area is around what is termed as ‘employee benefits’. These will now have to be accrued when they are earned (similar to pensions). This will include holiday pay, so that holiday outstanding at 31st March will need to be accrued and reflected in the accounts, requiring sophisticated HR systems to be in place. This is more of an issue where the organisation’s leave year is not the financial year. This could also include flexi-time accrued at the end of the financial year. This would have a financial impact on the ‘bottom-line’ of the revenue accounts for the first year of implementation, although the government could legislate to prevent this being a charge on council tax.

Planning and preparation

30. IFRS is a significant change to existing financial reporting and the volume and complexity of the new standards will present a challenge. This is not just a technical issue. It will require changes to processes and systems. Neither is this just a finance issue as it will also include HR, Property and Legal services. External advisors may be needed for the PFI changes.

31. A number of staff in Financial Services have attended training courses and CIPFA provided an in-house training course in December, which was also attended by a member of staff from Property Services.

Risk Management

32. If IFRS is not interpreted correctly in the council's accounts and implemented in accordance with the required timetable it would impact on the Auditor's opinion on the accounts and the Use of Resources score.

33. The management of this identified risk has commenced as evidence by attendance of staff on relevant training courses.

34. The successful delivery of unqualified accounts will require greater involvement from non-financial services staff than has previously been the case. A communications plan is being developed to raise awareness and IFRS will form part of the Council's financial training programme implemented as part of the Crookhall action plan.

35. Sound project management will be a crucial part of the process to keep the project on track and to identify potential problems at an early stage.

BACKGROUND PAPERS

None