

**REPORT TO: THE MORAY COUNCIL ON 17 MARCH 2010**

**SUBJECT: ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS**

**BY: CHIEF FINANCIAL OFFICER**

**1. REASON FOR REPORT**

- 1.1 To inform Members on the Council's adoption of International Financial Reporting Standards (IFRS).
- 1.2 This report is submitted to the Council in terms of Section A (17) of the Council's Administrative Scheme relating to accounts.

**2. RECOMMENDATION**

- 2.1 To advise Members of the implications for the Council of the introduction of IFRS and seek their support in meeting the timescales.**

**3. BACKGROUND**

- 3.1 In terms of Section 12 of the Local Government in Scotland Act 2003, the Council is required to prepare its annual accounts using "proper accounting practice".
- 3.2 Each year CIPFA/LASAAC issues a "Statement of Recommended Practice" (SORP). The SORP interprets the requirements of the United Kingdom Generally Accepted Accounting Practice (UKGAAP) for local authority purposes.
- 3.3 The Chancellor's 2007 Budget report made a commitment that public sector accounts would move from preparation on a UKGAAP basis to being prepared using International Financial Reporting Standards (IFRS). The move to IFRS for public bodies is intended to bring benefits in terms of consistency and comparability between financial reports in the global economy and to follow private sector best practice.

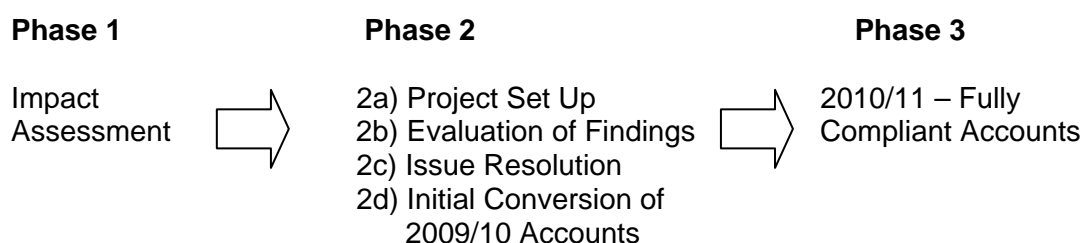
- 3.4 The main reason for adopting IFRS is to achieve consistency and comparability between financial reports and statements in the global economy. The private sector in the UK adopted IFRS in 2005. The new reporting regime will bring significant challenges for the Council, requiring revisions to accounting policy, changes in the format of Financial Statements and systems and a significant number of additional disclosures in the annual accounts.
- 3.5 The move to IFRS accounting is the biggest change in local government financial reporting for decades, and direct benefit to the citizens of Moray is questionable. The implementation work in this exercise is considerable and the Council must comply with this as it is a legal requirement.
- 3.6 The Accounts for 2010/11 will need to be fully compliant with IFRS and this requires comparative figures for 2009/10 to be available. Therefore, accounts for 2009/10 need to be prepared on both bases. As 2009/10 comparable figures for the 2010/11 accounts have to be produced on an IFRS basis, the effective date of transition is 1 April 2009 and so the Balance Sheet for 2008/09 (as at 31 March 2009) will also need restating to enable the 2009/10 accounts to be restated in IFRS format.

#### **4. IMPACT ON THE ANNUAL ACCOUNTS OF IFRS TRANSITION**

- 4.1 The changeover of the Council's annual accounts from UKGAAP to IFRS compliance will necessitate a variety of changes in approach. The main challenge facing the Council is to assess the potential impact on the reported financial position and the amount of staff time required to generate IFRS-based financial statements and working papers.
- 4.1.1 The impact of many of the IFRSs will be presentational with new terminology and statements being introduced and will significantly increase the level of disclosure notes required in the Statement of Accounts.
- 4.1.2 There are, however, a number of areas which will have a significant impact on the accounts and a small number which could potentially have an impact on the Council's General Fund or HRA Balances or increase the demands on the Local Taxpayer. CIPFA has been discussing with Scottish Government officials the need to consider whether legislation is needed to offset any effect the move to IFRS might have on budget requirements.
- 4.1.3 IFRS – The areas of change for local authorities are as follows:-
- Presentation of Financial Statements
  - Accounting Policies
  - Increased Disclosures
  - Inventories (Stock)

- Assets – Infrastructure , Intangible and Tangible
- Impairments to assets
- Leases
- Private Finance Initiatives or Public Private Partnerships
- Investment property/ Assets Held For Sale
- Council's Related party Transactions
- Group Accounts
- Accrual of Employee Benefits (Untaken Leave at 31 March)
- Provisions

4.1.5 The first time adoption, presentation of the Financial Statements will involve significant investment of staff time, and not just staff in the Finance Service. A phased approach is to be used for the implementation.



4.1.6 The key element of the phased approach is the Impact Assessment which is being undertaken by Accountancy and Estates staff. The objectives of this assessment are to

- Ensure that the principal issues arising during the transition to IFRS are identified;
- Evaluate these issues and assess the impact on the Council's financial position, processes , systems and people;
- Develop an implementation plan in respect of the issues identified, including an analysis of key decisions which need to be taken as well as the required timescales.

## **5. INITIAL IMPACT ASSESSMENT AND EVALUATION OF FINDINGS**

5.1 Work has commenced on this challenging agenda and a description of the work completed to date is described in this section. In some areas, it is already possible to draw a conclusion and in other areas, there is some way to go before we are able to assess the impact in terms of further work and resources required.

### **5.2 Financial Statements**

5.2.1 In order to prepare fully compliant accounts for 2010/11, the Council will be required to revise its accounting policies, change the format of its financial statements and include a significant number of additional disclosures.

- 5.2.2 The Council will have to complete the 2009/10 financial statements under UKGAAP and once audited and certified in September 2010, these statements will have to be reconstructed and restated to comply with IFRS. The Council will have 3 months to undertake this task as the deadline to pass the restated statements to External Audit for review is 31 December 2010. This task will be challenging as traditionally this 3 month period is when accounting staff involved in year-end work take a large part of their annual leave and work relating to estimated outturn figures is a priority.
- 5.2.3 For the first accounts to be published in 2010/11, the Council will need to restate the 2009/10 accounts. This will require an opening Balance Sheet as at 1 April 2009 to be prepared (in effect the closing 2008/09 Balance Sheet restated and published as part of the 2010/11 accounts). There will therefore be three Balance Sheets in the 2010/11 accounts, with a note reconciling the differences to the 2008/09 and 2009/10 accounts prepared under UKGAAP.
- 5.2.4 The current Financial Management system will have to be reviewed to identify potential coding structure changes and reports for the new financial statements for income and expenditure, movement in reserves, cash flows and balance sheets will have to be redesigned.
- 5.2.5 The Council will need to comply with the concept of cash equivalents and will need to restate cash balances in the Cash Flow Statement to include any short term investments deemed to be "cash equivalents". The Council will adopt the suggestion in the IFRS to treat any deposits or investments that will mature within three months as cash equivalents. The Council had £7.6million of current investments at 31 March 2009.

### **5.3 Inventories**

- 5.3.1 The IFRS approach to Inventories is similar to the current SORP requirements in that it requires stocks to be held at current cost (lower of cost or Net Realisable Value). The impact on the Council of this standard is expected to be minimal.

### **5.4 Fixed Assets**

- 5.4.1 Tangible fixed assets will be measured and recorded differently. In particular there will be greater emphasis on component accounting – component accounting is breaking assets down into smaller component parts. It is required where the value of the component is significant compared with the total value of the asset and the asset life/depreciation method or residual value of components differs. The new rules require significant components of assets to be depreciated separately. This means breaking down an asset into different elements with different useful lives and different depreciation rates as an asset is enhanced over its life.

- 5.4.2 The Council needs to be able to identify components when enhancements or revaluations take place. It also needs to identify impairment losses separately from revaluation losses.
- 5.4.3 The new approach required under IFRS brings about a substantial additional burden including changes to the Asset Register software maintained by Finance. A duplicate system will need to be maintained and run in parallel for the closedown in 2009/10 as the figures relating to asset revaluations, impairments etc will need to be calculated using both UKGAPP and IFRS.
- 5.4.4 Future Capital Programmes will be required to provide more detail to assist in identifying components of assets.
- 5.4.5 The definition of Investment Property in the IFRS code is that it is “used solely to earn rentals or for capital appreciation or both”. Any property that is used for service delivery cannot be classed as Investment Property. There is also a stricter definition of “Assets Held for Sale” which requires assets to be actively marketed and the sale expected to be completed within 12 months. The Council had Investment Properties and Surplus Assets held for disposal valued £6.788m and £3.830m respectively at 31 March 2009 which will require to be reviewed and reclassified where relevant for the restated accounts.
- 5.4.6 Investment Property will be measured at fair value or at cost where fair value cannot be reliably determined. These properties are currently valued at an open market basis and so the reclassification and new methodology of valuation will have an impact of the valuation of these properties. The list of Investment Properties is currently being reviewed by Accountancy and Estates staff to ascertain and quantify the impact.

## **5.5 Leases**

- 5.5.1 Property leases will be required to be separated into leases of land and leases of buildings and classified separately. In addition the IFRS code has given nine different questions that need to be answered in order to ascertain whether leases should be classified as a finance lease (where substantially all the risks and/or rewards incidental to ownership are transferred to the lessee) or an operating lease (where risks and rewards stay with the owner of the asset).
- 5.5.2 The correct classifications are required as each type of lease has a different impact on the financial statements. The Council has nearly 500 property leases and each of these has been reviewed and assessed against the following questions by Accounting and Estates staff.
- Does the lease transfer ownership of the asset to the lessee by the end of the lease term?

- Does the lessee have the option to purchase the asset at a price expected to be sufficiently lower than the fair value for it to be reasonably certain, at the inception of the lease, that the option will be exercised?
- At the inception of the lease, is it reasonable to assume that the lessee and lessor either (a) expected the lease term to be for the major part (at least 75%) of the economic life of the building (even if title is not transferred), or (b) that the residual value on expiry of the lease term would be negligible?
- Are the buildings of such a specialised nature that only the lessee can use them without major modification?

If the nature of the lease was apparent after this initial assessment, then no further appraisal was required.

5.5.3 The review of the property leases has indicated that most of the Council's land and buildings leases are classified as operational leases and of the few leases that are finance leases, calculations have shown that there will be minimal impact on the Council's balance sheet.

5.5.4 Information has been collated from schools and other relevant budget holders to ascertain any other leases or contracts which the Council currently undertakes. It has been difficult to obtain this information but from the information received (84 leases) it is expected that these leases will all be classified as operational leases which will continue to have the same treatment under IFRS and have little impact on the Councils revised financial statements.

5.5.5 IFRS also requires the Council to identify its wider contracts and arrangements which may not be leases in legal form but may have "Arrangements which may contain a lease" A good example of this is a PPP scheme where the Council would pay for the asset over a period of time through its Unitary Charge which at first glance is a charge for a "service".

5.5.6 The Council is not expected to enter into a PPP arrangement until April 2010. Other contracts will be reviewed to ascertain where the Council has exclusive use or control over the assets used to deliver the contract as this is deemed to be equivalent to a lease and may have implications for the financial statements. Accountancy section is currently collating information from services on leases and contracts and working closely with Estates staff on valuations.

## **5.6 Intangible Assets**

5.6.1 Internally generated intangible assets “must” be capitalised as opposed to UKGAPP which “allows” these cost to be capitalised. This relates mainly to development costs attributable to computer systems developed in-house. The IFRS code does not significantly impact on the treatment of purchased intangible assets such as computer software licences. The Council does not have any intangible assets on its Balance Sheet at 31 March 2009 but has recently approved the use of a National Contract for the purchase of Microsoft licences which will be reviewed and may create new intangible assets for 2009/10.

## **5.7 Employee Benefits**

5.7.1 Under IAS 19 the Council is required to take account of benefits accumulated by employees but not taken at the balance sheet date (31 March) i.e. any benefits should be recognised in the financial year in which it is earned rather than received. Such benefits include annual leave, flexi time etc.

5.7.2 There are a number of different holiday entitlements across the Council. As the holiday year runs from 1 January to 31 December, there will be a holiday pay accrual as at 31 March. The current system to record leave is manual and is carried out within each department.

5.7.3 The accrual is calculated by counting the number of unused holiday hours for each staff member at the year-end and multiplied by their hourly rate (plus salary on-costs). For School Teachers, it is straight-forward to apply a formula. For other staff, it is proposed than an estimate be calculated using a 10% sample.

5.7.4 Samples of around 25 for each group (434 employees in total) were taken and the following information obtained from budget managers in order to calculate this sum.

- Annual Leave entitlement
- Leave taken from 1 January 2009 to 31 March 2009
- Flexi Leave Scheme in place
- Flexi Time balance at 31 March 2009
- TOIL scheme in place
- TOIL balance as at 31 March 2009

5.7.5 This exercise has proven very difficult to undertake as the following issues were found.

- Leave cards are not maintained for all staff.
- There is no consistency of systems to provide flexi leave information and the electronic system in HQ is limited to 6 months data.
- Staff and managers were reluctant to supply the data.
- There is not a consistent approach across the Council in how annual leave is calculated for part time staff.
- There was not a consistent approach to applying 5 years+ continuous service – some employees were receiving the higher annual leave staff entitlement when they had “broken” service.
- Public Holidays are treated differently for different groups of workers e.g. Waste only receive 2 public holidays at Christmas and the remaining entitlement is added to their annual leave total as they are expected to deliver a service during this time.
- Homecarers leave is calculated on the hours they have worked in a 13-week period.
- Janitors / caretakers have additional entitlement for frost protection
- Some employees only work seasonal periods e.g. gardeners.

A report will be provided to the Corporate Management Team on this exercise to seek their support in getting Managers to supply information timeously and in achieving consistency in the calculation of annual leave entitlement across the Council.

5.7.6 This exercise has taken a considerable amount of time and resource to complete and will have to be repeated each year. Accountancy staff are discussing these challenges with Personnel and Payroll to see if the exercise can be streamlined for March 2010.

5.7.7 The Scottish Government have recognised that there will be a major impact of this accrual on Council Tax/Rent payers and have issued draft Guidance for consultation which will allow the Council to make a statutory adjustment to exclude the value of any accrual created for employee benefits to be deducted and so negate any impact on the General Fund or HRA. Initial assessment shows this accrual to be around £2 to £3million.

5.7.8 The approved guidance is expected to be received before 31 March 2010. This is similar to other adjustments like the Council's Pension Liability where Local Authority Accounts are required to be prepared on the same basis as the private sector and then adjusted to allow for the impact of the accounting treatment on the local council Tax or Rent payer. The adjustments result in accounts which are much more difficult to interpret.

5.7.9 IFRS also covers benefits such as sick pay, long service awards and redundancy payments. Accountancy staff will review these payments to ensure that they do not give rise to a material sum which will have to be accrued for.

## **5.8 Group Accounts**

5.8.1 The Council currently consolidates four associates into its Group accounts, Grampian Joint Police Board, Grampian Joint Fire and Rescue, Grampian Valuation Joint Board and Moray Leisure Limited. It also acts as Trustees for a number of Trusts and Common Good Funds. The funds do not represent assets of the Council and are not included in the Council's Balance Sheet, although they are consolidated in the Group Accounts. A number of partnerships/interests are excluded on materiality grounds but are detailed in a note to the accounts.

5.8.2 The main change under IFRS is that for a company/organisation to be included within the Group Accounts for the Council, the required test is that the Council only needs to be able to demonstrate the **ability** to exercise control over the company/organisation, rather than **actually** exercising control (currently through voting rights or financial dependence). All partnerships will be reviewed against the revised criteria and the decision to include or exclude the entity from the Group Accounts will be agreed with External Audit

## **6. IMPLEMENTATION OF IFRS**

6.1 The preceding section has highlighted the major changes to the Council's annual accounts that will take place through IFRS implementation. The move to IFRS based financial reporting presents a significant challenge to the Council, due to the volume and complexity of the Standards. Experience from the private sector has shown that the move is both lengthy and complex and will involve regular discussions with External Auditors and the CIPFA Technical Team.

6.2 In recognition of the complexity of implementation it has been necessary for the Chief Financial Officer to engage technical advice from a firm of Accountants to support the Accountancy Section to ensure compliance with the International Accounting Standards. This contract has been capped at £10,000 in total over the two financial years (2009/10 and 2010/11). The cost of this service will be funded from savings generated by the current vacant posts in Accountancy Section.

6.3 The key dates for the implementation of IFRS compliant accounts are set out in **APPENDIX 1** with a summary action plan.

- 6.4 There will be substantive changes under IFRS to the main accounting statements and systems. The overall effect is still being clarified and is dependent on the issue of future guidance from CIPFA and Scottish Government.

## **7. SUMMARY OF IMPLICATIONS**

### **(a) Single Outcome Agreement/Service Improvement Plan**

None.

### **(b) Policy and Legal**

The Local Government in Scotland Act 2003 tasks the Chief Financial Officer as the Section 95 Officer for the Council to prepare annual accounts using “proper accounting practice”. The Council’s External Audit carries out an audit of these accounts to ensure the Council complies with all the latest statutes and guidance.

### **(c) Resources (Financial, Risks, Staffing and Property)**

If the Scottish Government do not issue the statutory guidance to allow the Council to reverse the impact of the accrual in respect of employee benefits, indications are that this is likely to be several millions and will have a major impact on Council Tax/Rent.

The cost of engaging external technical support has been capped at £10,000 in total over the financial years 2009/10 and 2010/11. The cost of this service will be funded from the savings generated from vacancies in Accountancy Section.

Considerable input will be required by staff in Accountancy and Estates Sections. Systems and procedures will have to be changed in order to streamline the year-end closure in future years. This may require input from Personnel, Payroll and ICT services.

The risk for the Council of the transition to IFRS is qualification of the 2010/11 Financial statements by the Council’s external auditor. The key points for us to focus on in this regard are:

1. Restatement of 2008/09 Balance Sheet and Notes – due 31 December 2009 – revised deadline 31 March 2010.

2. Restatement of 2009/10 Accounts – due 31 December 2010 – Completion of estimated outturns will remain the highest priority followed by work on the DBS programme. All remaining Accountancy resources will be focussed on the restatement of the accounts from September 2010 to 31 December 2010.

**(d) Consultations**

None.

**8. CONCLUSION**

**The implementation of IFRS compliant annual accounts will present a significant challenge for the Council. A plan has been prepared in response to this challenge and work has commenced on the transition process. If the Council does not manage to make the necessary changes for compliance with the International Financial Reporting Standard, it is likely that the external auditor will qualify the Council financial statements for 2010/11. A progress report will be provided to Members towards the end of the calendar year.**

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