Progress on the transition to IFRS

Countdown to IFRS in local government

October 2010

The deadline for local authorities to produce accounts compliant with International Financial Reporting Standards (IFRS) is fast approaching. Successful implementation of IFRS will testify to the ability of local government to manage a major change in its financial arrangements. Failure, on the other hand, could result in late or qualified opinions on accounts and will reflect badly on the reputation of individual authorities and, potentially, the sector as a whole.

Auditors report that there has been good progress overall between November 2009 and July 2010. Local authorities need to build on this to ensure they will prepare IFRS-compliant accounts for 2010/11 by the statutory financial reporting deadline. In particular, the restatement work that most authorities plan to carry out this autumn will help them to identify the areas they need to address as they move closer to the final stages of IFRS implementation. Some authorities are not making as much progress as others and need to overcome more significant challenges to IFRS implementation. Locally, auditors are discussing with them the areas where they need to do more.

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Authorities need to act now, if they have not already done so, to:

- restate 2009/10 accounts by the end of December 2010 at the latest;
- produce 2010/11 skeleton accounts including disclosures;
- improve information and systems to analyse non-current assets into separate components; and,
- ensure they have identified, reviewed and classified their lease arrangements.

Audit committees have a key role to play in this process

Audit committees have a key role to play in this process and are well placed to challenge the progress of IFRS implementation in their authorities. Local authorities should also continue to discuss emerging IFRS issues with their appointed auditors.

Local authorities will need to prepare full IFRS-compliant financial statements under the new *Code of Practice on Local Authority Accounting for 2010/11* (the Code of Practice) by 30 June 2011. This is challenging but local authorities have benefited from a staged introduction of some IFRS requirements. Accounting for financial instruments changed from 2007/08, and *IFRIC 12: Service concession arrangements* has been implemented in 2009/10. Local authorities can also learn from NHS and central government bodies, as these prepared IFRS-compliant accounts one year earlier in 2009/10.

This briefing paper draws on a survey of auditors of all single tier, county and district councils, fire and rescue authorities, and police authorities on progress in implementing IFRS. The survey took place in July 2010 and there was a 100 per cent response.[i]

In the survey, auditors assessed authorities' progress overall and in several technical areas. In particular, we asked auditors to assess whether, in their view, authorities were on track to prepare IFRS-compliant accounts by the end of June 2011 as follows:

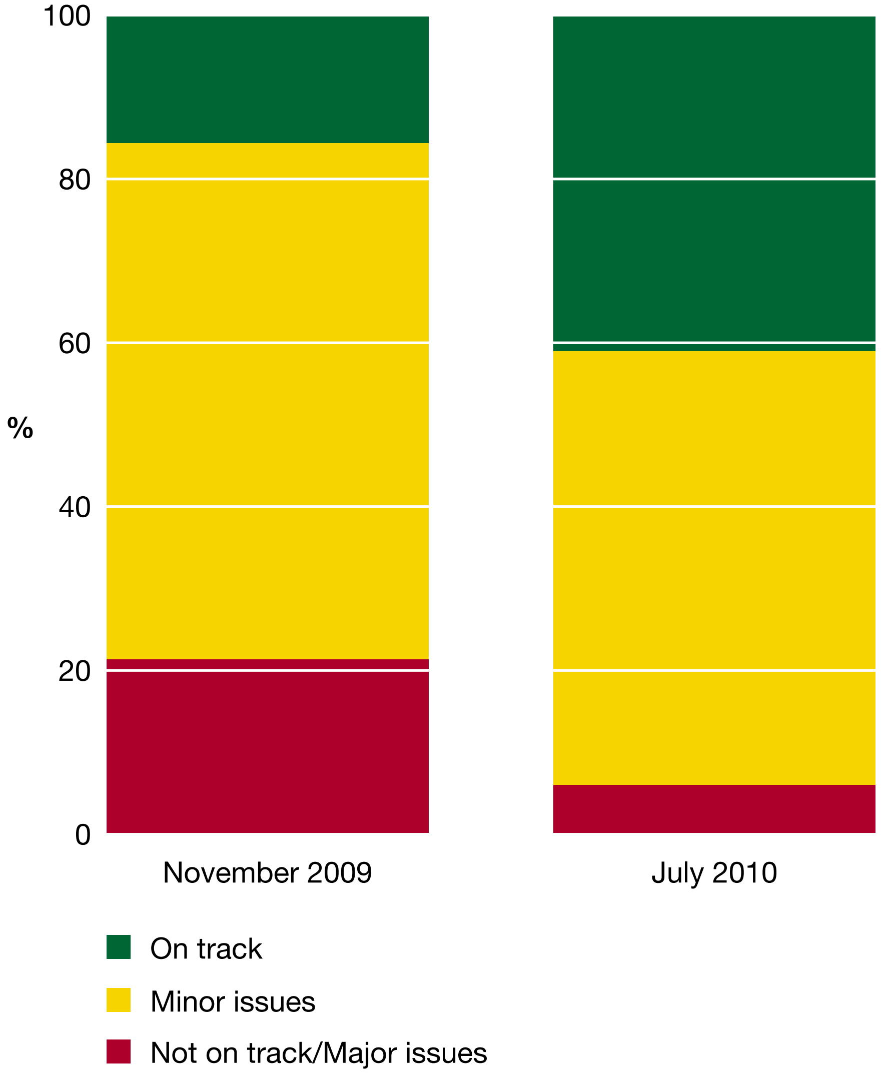
- Red: not on track to prepare IFRS-compliant accounts or facing major issues;
- Amber: there are minor issues to address to get on track; or
- Green: on track to prepare IFRS-compliant accounts.

In this paper we make comparisons with a baseline assessment made in November 2009, and set out the lessons from the NHS experience of transition. We also outline key actions that authorities now need to take.

i Our survey did not cover progress on implementation of IFRIC 12, which will be reported in *Auditing the Accounts* in November 2010 when the results of audits of 2009/10 accounts will be available.

Overall local authorities are making progress but there is more to do

Figure 1: **Comparison of overall auditor assessment: November 2009 and July 2010**



Source: Audit Commission

In November 2009, auditors reported that only 15 per cent of authorities were on track to produce IFRS-compliant accounts; this improved to 41 per cent by July 2010. In November 2009, 21 per cent of authorities were considered to be facing serious difficulties with implementing IFRS, while by July 2010, this had reduced to 6 per cent. In July 2010, auditors also reported that around half of authorities had minor issues to resolve.

Therefore, overall there has been good progress but some authorities still face more significant challenges to IFRS implementation. Where local authorities fail to address issues there is a risk that auditors will qualify opinions on accounts or there will be delays to publishing accounts. At a practical level, if local authorities delay resolving any outstanding issues they risk incurring extra and unnecessary costs.

Progress against recommendations made in February 2010

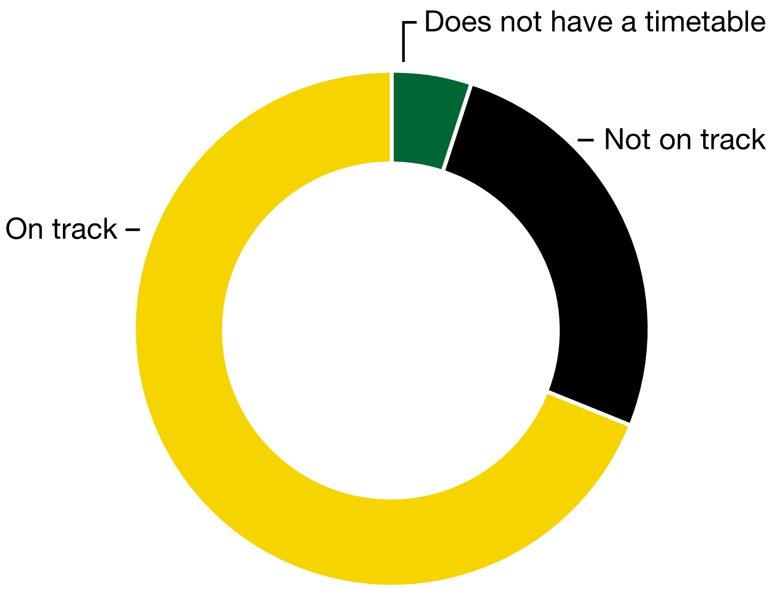
In our February 2010 briefing, *Countdown to IFRS*, we recommended the following actions that local authorities could take to manage the transition to IFRS:

- develop and maintain a detailed project plan including a budget and resource plan;
- conduct a detailed impact assessment;
- engage the wider organisation because IFRS is not just a finance issue;
- ensure that their audit committee or equivalent is aware of the implications of IFRS; and
- begin a dialogue with their external auditor on the authority's plans and progress, and the issues arising.

We have revisited these recommendations to assess progress between November 2009 and July 2010.

Recommendation	Progress as at July 2010
Develop and maintain a detailed project plan, including a budget and resource plan	■ Generally, there has been good progress. Auditors reported that 95 per cent of authorities have a project plan in place, compared with 77 per cent in November 2009. ■ Nearly 70 per cent of authorities were assessed by auditors as being on track to produce IFRS-compliant accounts against their own project plan timetable (Figure 2). ■ However, this means that 31 per cent (over 120 bodies) are behind their project plans. Those who have not developed a detailed project plan or are behind their plans, should act urgently to bring work back on track.

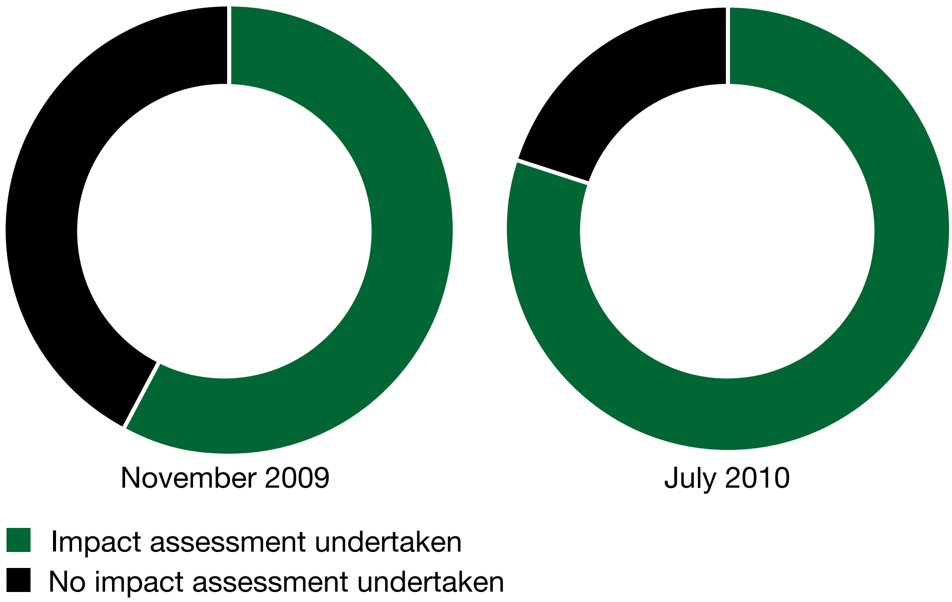
Figure 2: **Progress against project plan timetable – July 2010**



Source: Audit Commission

Recommendation	Progress as at July 2010
Conduct a detailed impact assessment	■ Just over 80 per cent of authorities have now undertaken an impact assessment, a significant improvement from the November results (58 per cent). ■ It is important that authorities continue to update their impact assessments regularly by reflecting findings from technical analysis and new and emerging issues.

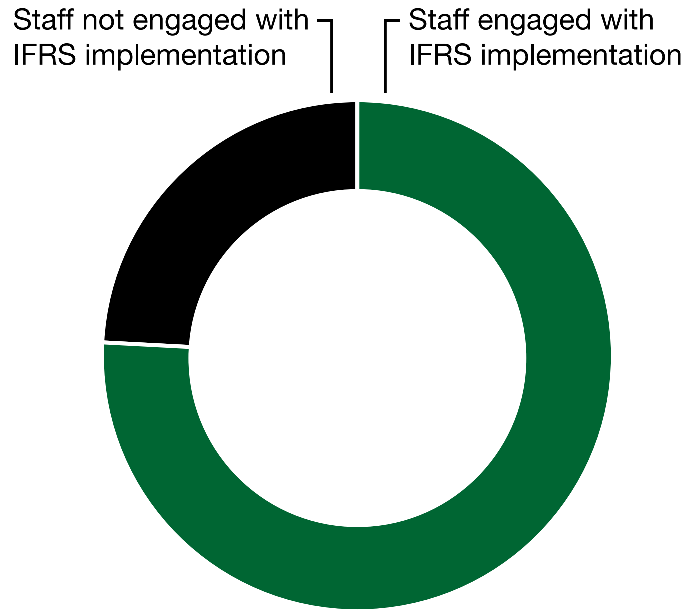
Figure 3: **Progress of impact assessments**



Source: Audit Commission

Recommendation	Progress as at July 2010
Engage the wider organisation, because IFRS is not just a finance issue	■ Auditors report that 76 per cent of bodies have ensured that relevant staff in the wider organisation, and not just those working in finance, are engaged with the process of IFRS implementation (Figure 4). ■ Local authorities need to continue to involve a wider range of staff within their organisations as IFRS is not just a transitional issue; they need to embed changes throughout the organisation to ensure they continue to record transactions and collect data in future years. ■ There are potential wider benefits to making these changes, as they may lead to better management information on, for example, lease and contract commitments, and employee benefits.

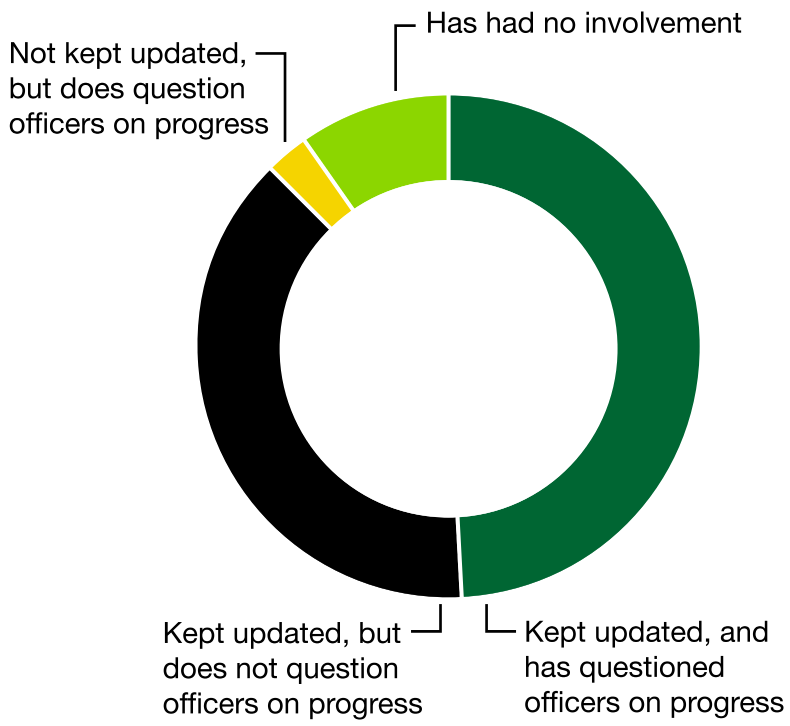
Figure 4: **Wider staff engagement in IFRS implementation - July 2010**



Source: Audit Commission

Recommendation	Progress as at July 2010
Ensure the audit committee, or equivalent, is aware of the implications of IFRS	■ Audit committee engagement is essential. The survey results for July 2010 show that 88 per cent (Figure 5) of finance departments have updated audit committees on the IFRS transition, compared with 46 per cent in November 2009. But 48 per cent of committees are still not challenging finance departments on progress or have had no involvement (Figure 5). ■ Audit committees are a key source of assurance for managing risk and maintaining an effective control environment. They need to challenge officers and ensure IFRS transition plans are on track.

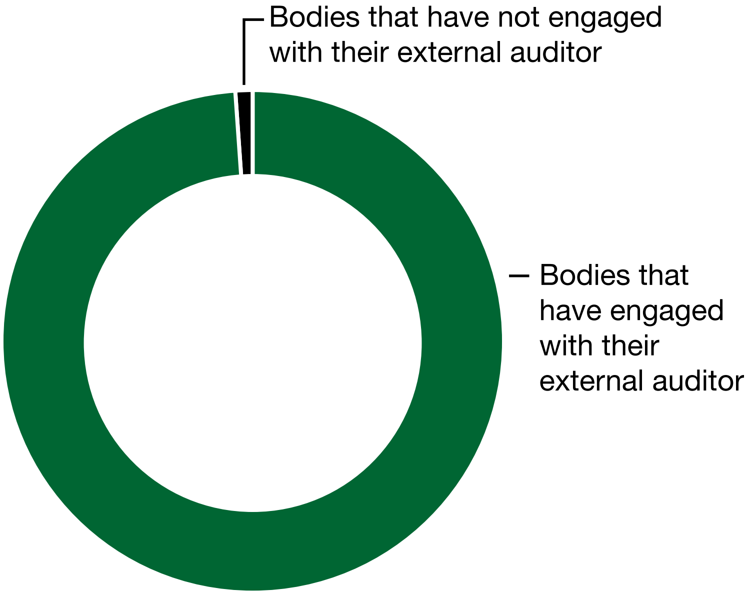
Figure 5: **Audit committee awareness of IFRS - July 2010**



Source: Audit Commission

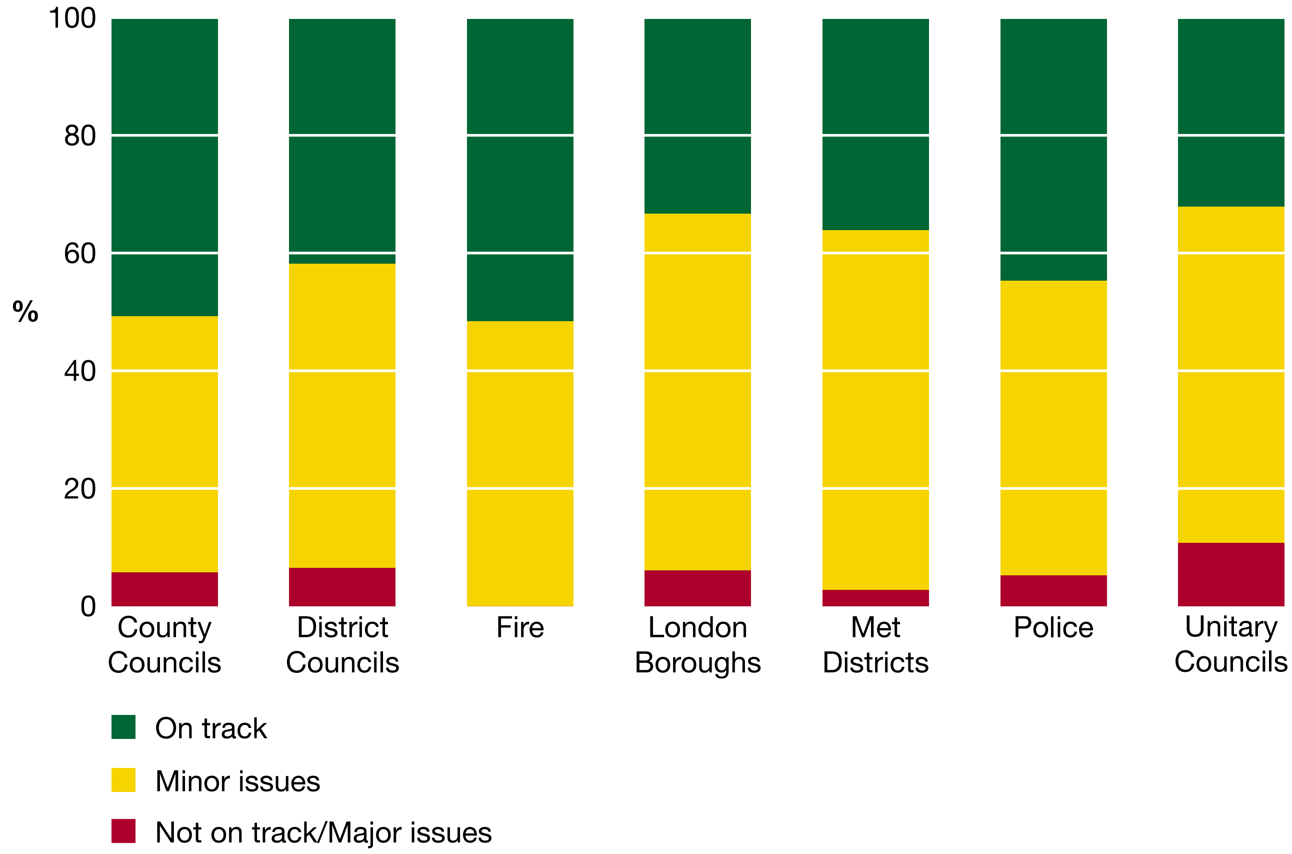
Recommendation	Progress as at July 2010
Begin a dialogue with the external auditor on the authority's plans and progress, and the issues arising.	■ It is encouraging that 99 per cent of bodies have engaged with their external auditor as at July 2010. ■ As local authorities start restating 2009/10 accounts and producing skeleton accounts for 2010/11, it is important that they continue to discuss emerging issues with auditors, and share the results of restatement and other preparatory work.

Figure 6: **Engagement with external auditor**



Source: Audit Commission

Figure 7: **Red, Amber, Green overall assessment by authority type**



Source: Audit Commission

Progress in IFRS implementation varies slightly by type of authority. The auditor survey for July 2010 showed that, overall, fire authorities are the furthest ahead, with the highest percentage of green assessments. The variation is greater in specific technical areas, where police and fire authorities have more green assessments than other types of authority. This perhaps reflects the fact that, as single-service organisations, the range and number of their assets are smaller. Unitary authorities have the highest percentage of red assessments and London boroughs and metropolitan boroughs have the highest percentage of amber assessments.

These results suggest that larger, more complex authorities are finding the transition to IFRS more challenging because of the scale of activities they need to undertake. The volume of information to review is greater at larger, multiple-service authorities, and authorities should consider this when updating project and resource plans.

Local authorities should aim to complete key steps in IFRS transition by 31 December 2010

Restating balances for 2009/10

NHS and central government bodies were required to complete an exercise to restate audited 2008/09 comparatives during summer 2009 – a year before they were due to prepare IFRS-compliant accounts for the first time. While there is no formal requirement for local authorities to do this, the experience of IFRS implementation in NHS and central government bodies suggests it is an important exercise and it is a key step for local authorities.

In the NHS, nearly one-third of all bodies identified accounting or information issues that they needed to resolve as part of the restatement exercise. Most commonly, the outstanding issues were legal charges,[i] leases, LIFT and PFI accounting, and PPE (or non-current asset) valuations. We therefore recommend that local authorities do this work as early as possible, in case they identify any significant financial reporting issues that they will need to resolve before preparing draft accounts.

In July 2010, auditors reported that 25 per cent of authorities planned to restate their 2009/10 accounts by the end of September 2010. In addition, 70 per cent were planning to restate their 2009/10 accounts between 1 October and 31 December 2010. The latter timetable is slightly later than in the NHS but, although tight, should allow enough time to resolve major issues.

Producing skeleton accounts for 2010/11

As well as restating 2009/10 accounts, auditors reported that 81 per cent of local authorities planned to prepare a set of skeleton IFRS accounts for 2010/11 by 31 December 2010. As part of this, local authorities should also make sure that they include work on disclosures. Central government and NHS experiences show that identifying and preparing relevant new IFRS disclosure notes can be more challenging than expected. In the NHS, the accuracy and completeness of disclosures became a more significant financial reporting issue during the final accounts audit. We believe this is because there was less attention paid to disclosures during earlier stages in the transition. Local authorities should therefore start work on preparing disclosure notes as part of producing 2010/11 skeleton accounts and other preparatory work.

Identifying and preparing relevant new IFRS disclosure notes can be more challenging than expected

i Many NHS bodies (usually primary care trusts) are involved in arrangements where they have a legal charge over property owned by a third party, can specify that the properties are used for health purposes and set other conditions on the use of the property. Under IFRS these arrangements had to be reviewed to determine whether they should be accounted for according to *IFRIC 12: Service concession arrangements*, or *IFRIC 4: Determining whether an arrangement contains a lease*.

Those authorities planning to restate 2009/10 accounts or prepare skeleton accounts after December 2010 should ensure they allow sufficient time to complete the work and deal with any issues that arise.

Authorities need to work on developing accounting policies, processes and systems for componentisation as soon as possible

As part of the restatement and skeleton accounts process, local authorities and their external auditors should work together. Although auditors are not required to report specifically on, or give an opinion on, early restatement work, the restated comparative figures will form part of the 2010/11 audit work on opening balances. Therefore authorities and auditors may wish to discuss approaches during restatement and skeleton accounts work.

Componentisation requires immediate action

Of the technical areas covered in the survey, auditors reported that authorities had most work to do on non-current assets (formerly fixed assets). Auditors considered that 56 per cent of bodies faced minor issues (amber), while 8 per cent were not on track (red). The survey highlighted the key issue here was the requirement to account for and depreciate significant components of material assets separately, or 'componentisation.'

For local authorities, the Code of Practice has adapted *IAS 16: Property, Plant and Equipment* to apply componentisation prospectively. This means local authorities do not have to restate comparative figures for significant components as part of the initial transition to IFRS accounting. However, they need to establish the accounting policy for componentisation of their assets, and apply the policy as assets are acquired, enhanced or revalued from 1 April 2010. In practice, this means there is likely to be a phased approach in local authorities to introducing componentisation across all their assets. Although this gives local authorities some more time to meet the requirements, this will also require careful maintenance of records so it is clear which assets have been recognised and depreciated on a component basis.

Authorities need to work on developing accounting policies, processes and systems for componentisation as soon as possible. They need to identify the significant components of their major assets and may need to make changes to fixed asset register systems to enable them to recognise and depreciate components separately. It may be useful to discuss componentisation with other professionals, such as valuers, surveyors and engineers working on maintenance programmes, to identify the significant components of major assets, and to establish the planned timescales for revaluing or enhancing significant components. Early preparatory work will make it easier for local authorities to apply componentisation requirements to those assets enhanced, revalued or acquired from 1 April 2010.

Auditors reported some common problems related to componentisation. Collecting the information, rather than technical accounting, was viewed as the main difficulty. This was partly because of the size and complexity of asset bases, although having inadequate fixed asset registers added to the problem. Auditors reported that some local authorities have prioritised other areas so far and have lacked staff capacity to make progress on this issue.

A significant component is one that has:

- a significant value for the asset as a whole; but
- a significantly shorter useful life and will require replacement on at least one occasion during the life of the asset as a whole.

In our technical briefing paper, *Managing the practical implications of restating non-current assets*, we suggested the components in Table 1 may be significant in local authorities:

Table 1: **Suggested significant components of major assets**

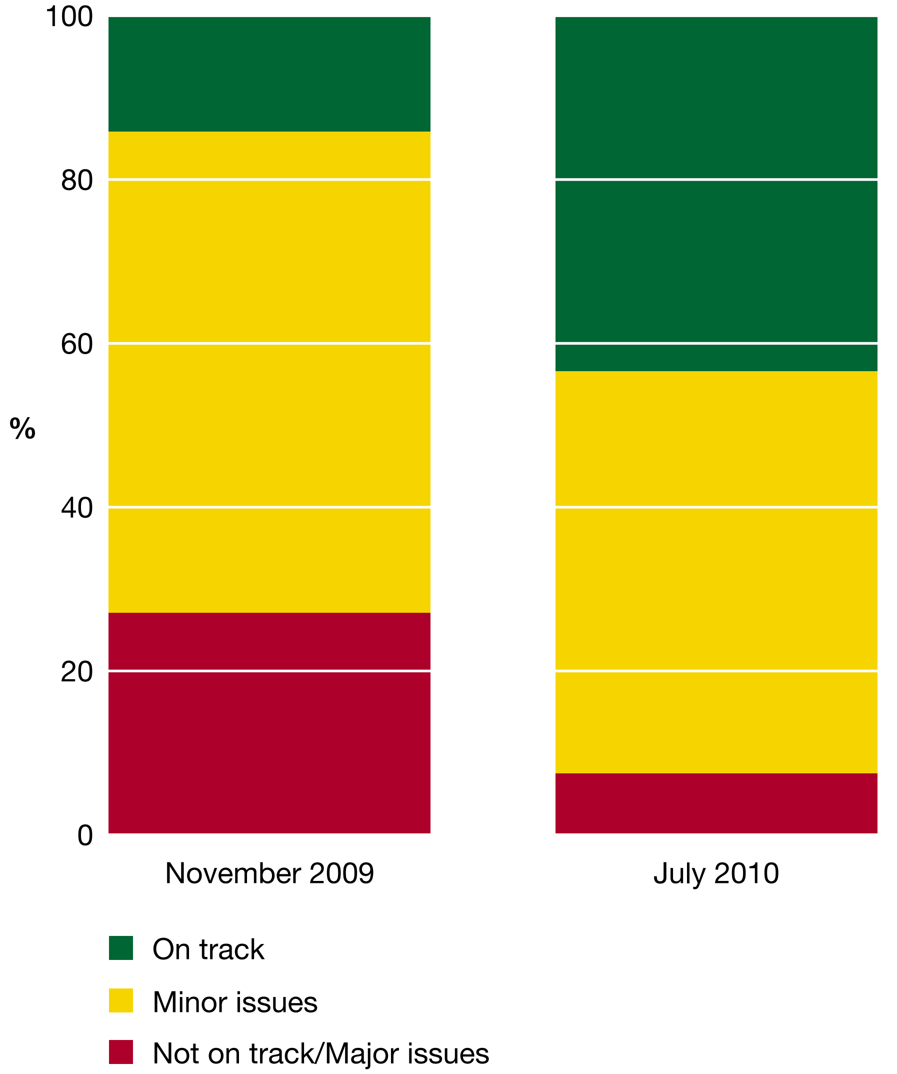
Type of asset	Possible components
Administrative buildings and schools:	■ Boiler and heating systems ■ Lifts ■ Electrical rewiring ■ Flat roofs
Housing stock:	■ Kitchen and bathrooms ■ Boiler and heating systems in tower blocks ■ Lifts
Leisure centres and swimming pools:	■ Boiler and filtration systems

Source: Audit Commission

We expect the transition to IFRS reporting for non-current assets will be more challenging for authorities with a bigger, more diverse asset base, or with a large amount of housing stock. Different management arrangements (for example, whether in-house or outsourced) may require different approaches and timescales for gathering information. Local authorities will therefore need to consider the nature and management of their non-current assets when deciding how much time and resource to commit to this area.

Authorities need to ensure they have identified all lease arrangements

Figure 8: **Comparison of auditor assessment for leases: November 2009 and July 2010**



Source: Audit Commission

In our November 2009 survey, we identified accounting for leases as one of the key problem areas for authorities. Auditors considered that only 14 per cent of authorities were on track to deliver accounts compliant with *IAS 17: Leases*. Twenty-seven per cent had major issues in this area, while 59 per cent had more minor issues. In the July 2010 survey, auditors reported that local authorities were making good progress with 43 per cent on track and 49 per cent having minor issues.

Authorities need to build on the good progress made on lease accounting to make sure they identify all material arrangements. Experience from the private sector and the NHS shows identifying all lease arrangements can be time consuming and resource intensive. In local authorities, where the number of potential lease arrangements is much greater, authorities need to ensure their project plans include enough time and resources to identify, review and classify all material leases and arrangements. Otherwise, there is a risk that draft accounts will include material misstatements, or that there will be inadequate evidence to support the accounting treatment for leases within the financial statements.

We expect that local authorities that have a large volume of lease arrangements may experience more difficulties in this area. In our previous technical briefing paper, *Identifying and accounting for leases*, we set out some risk-based methods to manage the process of reviewing lease arrangements.[i] For example, authorities can review a sample of lease contracts for a class of leases where contracts are standard and extrapolate the results across the whole class. This may help to manage the volume, but it is important authorities using risk-based methods to review leases can show that their approach is robust.

Local authorities should act now to avoid late emerging issues

The NHS experience has shown that unexpected accounting issues can arise at a late stage. During the NHS restatement exercise in summer 2009, the Department of Health had to issue guidance to NHS bodies on how to account for 'legal charges', an issue that had not been identified before.[ii] Other issues arose during preparation of final accounts in the NHS, particularly in areas which had not been considered in detail earlier, such as segmental reporting.

i For more information on the process of reviewing lease arrangements, see *Identifying and accounting for leases*

ii More information can be found in *NHS IFRS briefing paper 7*

Segmental Reporting

Auditors reported there was some uncertainty among local authorities on how to interpret the standard on segmental reporting

One of the disclosures that local authorities should start to consider at an early stage is segmental reporting. The Code of Practice for 2010/11 has adopted *IFRS 8: Operating segments* in full. Auditors reported there was some uncertainty among local authorities on how to interpret the standard. The core principle of the standard is that segmental reporting should aid users of the accounts to understand the entity's business activities and the economic environment in which it operates. The key criterion for segmental reporting is that it should be based on internal management reporting to what the standard calls 'the chief operating decision maker'. The standard also sets out 'aggregation criteria', which allow segments with similar economic characteristics to be reported as a single operating segment.

The segmental reporting note will thus enable authorities to present the information included in the financial statements in the same way as it is normally reported to officers and members during the year. This means that segmental reporting will not be consistent, even across the same types of local government body. However, it is important that local authorities can show their segmental reporting disclosures reconcile back to the Comprehensive Income and Expenditure Statement and the BVACOP (Best Value Accounting Code of Practice) service expenditure analysis. This could also help make it easier to explain the accounts to users, by showing how figures in financial statements reconcile to those reported internally.

Other technical areas – employee benefits and group accounts

Our earlier report, *Countdown to IFRS*, identified two more key technical areas: employee benefits, and group accounts.

A major change arising from implementing *IAS 19: Employee benefits* is the requirement to account for:

- short-term compensated absences (such as accrued annual leave entitlements); and
- long-term disability benefits.

In July 2010, auditors reported that 64 per cent of authorities were on track to comply with *IAS 19: Employee benefits*, and only 3 per cent had major issues. Problems in this area mainly related to practical difficulties such as incomplete records, systems issues and sampling approaches. Our previous technical briefing paper, *Accounting for Employee Benefits* provides guidance on how to tackle these practical issues.

On group accounts, auditors reported in July 2010 that of the 125 authorities who had completed their impact assessment and identified the need to prepare group accounts under IFRS, 49 per cent were on track, 41 per cent had minor issues and 10 per cent had more significant problems. Preparing group accounts is likely to be more challenging for those authorities (24 as at July 2010) who have identified a requirement to prepare group accounts for the first time, because of the different definition in IFRS of 'control' over entities.

Overall, these two areas do not appear to pose major problems for most authorities. However, individual authorities need to consider the risks for their own accounts. Where there are any outstanding practical issues or delays in identifying which entities need to be included in group accounts, authorities should resolve these well before they start to prepare accounts for 2010/11.

Overall conclusions

The auditor survey in July 2010 shows that many local authorities have made good progress in implementing IFRS and are actively dealing with potential significant financial reporting issues.

However, local authorities need to maintain or increase the momentum in identifying and resolving any remaining issues. Even seemingly minor issues that are left unresolved can create problems during preparation of accounts. They can also lead to more audit queries, with impacts on costs and resources. We expect accounting for non-current assets, particularly componentisation, to be a key area that local authorities should start to work on now, if they have not already done so. Alongside this, work on restatement and skeleton accounts should be considered as essential and urgent next steps in the transition to IFRS.

Local authorities need to maintain or increase the momentum in identifying and resolving any remaining issues

Further information

We have encouraged auditors to discuss the issues summarised in this briefing paper with authorities they audit.

Local authorities may also find it useful to read our latest *NHS IFRS briefing paper 8: Learning lessons from the audit of NHS IFRS-compliant accounts for 2009/10*. This sets out findings from a survey of auditors of NHS bodies, significant financial reporting issues that arose during the audit and lessons for bodies reporting under IFRS for the first time in 2010/11.

We will continue to support and report on the implementation of IFRS in local government in the coming months, through publishing:

- a technical briefing paper on segmental reporting in Autumn 2010; and
- our *Auditing the Accounts* report in November 2010, which will report on implementation of *IFRIC 12: Service concession arrangements* in the 2009/10 accounts.

We are also planning a third and final auditor survey to follow up progress on IFRS restatement work and other preparations in January 2011. We will share any key findings in time to support the accounts and audit process for 2010/11.

Please visit www.audit-commission.gov.uk/IFRS for more information about IFRS and to view previous briefing papers.