

## Argyll and Bute Council

Review of arrangements for implementation of International Financial Reporting Standards (IFRS)

April 2011



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## Introduction and background

Local authorities are required to comply with the Code of Practice on Local Authority Accounting in the United Kingdom (the Code). From 2010/11 this Code will be based in International Financial Reporting Standards (IFRS) rather than a UK GAAP based Statement of Recommended Practice (SORP). The Code requires a restated balance sheet at 1 April 2009, restated 2009-10 accounts and full published IFRS accounts for 2010-11.

Auditors do not have any direct reporting responsibilities in respect of transition balances although they will from the opening balances for the comparative period.

Our work has taken the form of an arrangements review intended to provide feedback on the Council's approach to restatement and is not an audit of the restated balance sheet figures. Detailed work on the restated figures will take place during the 2010-11 final accounts audit.

The arrangement review is primarily focused on 1 April 2009 restated balance sheet values, which will be required to report the 1 April 2010 opening balances for 2010-11. This work has been undertaken as part of our planning for the 2010-11 financial statements audit.



## Adequacy of arrangements

### Basis of assessment

This report details the findings of our review. For each significant balance sheet items we have considered the effectiveness of the Council's arrangements in each of the following key areas:

- identification and reporting of accounting policies
- identification and reporting of adjusted UK GAAP values at 1 April 2009
- support and advice to report asset valuations required under IFRS
- restatement of notes to the balance sheet
- quality of supporting working papers

The Council's arrangements for each line in the balance sheet have been assessed using a red/amber/green (RAG) rating using the following definitions:

<b>Green</b>	Adequate arrangements appear to be in place for the balance sheet area to provide not materially misstated amounts for the restatement.
<b>Amber</b>	Adequate arrangements are in place in some respects for the balance sheet area to provide not materially misstated amounts for the restatement. Evidence that the Council is taking forward areas whether arrangements need to be strengthened.  Further audit evidence required to support the underlying figures.
<b>Red</b>	The Council's arrangements are generally inadequate to provide not materially misstated amounts for the restatement.

Our findings are detailed on pages 3 and 4 of this report. Where items and areas have been assessed as amber or red we have discussed these with officers and as appropriate made recommendations on page 5.

## Summary of findings

### Assets

Balance sheet item	Accounting policies	UK GAAP values	IFRS values	Supporting notes	Working papers	Overall assessment
Property, plant & equipment						
Investment properties						
Intangible assets						
Non-current investments						
Non-current trade & other receivables						
Non-current other assets						
Inventories						
Trade & other receivables						
Investments						
Other current assets						
Cash & cash equivalents						
Assets held for sale						

**Liabilities**

Balance sheet item	Accounting policies	UK GAAP values	IFRS values	Supporting notes	Working papers	Overall assessment
Trade & other payables						
Bank overdraft						
Current borrowings						
Current financial liabilities						
Current provisions						
Other current liabilities						
Non-current trade & other payables						
Non-current borrowings						
Non-current financial liabilities						
Non-current provisions						
Non-current other liabilities						
Taxpayers equity						

**Other areas**

Area	Accounting policies	UK GAAP values	IFRS values	Supporting notes	Working papers	Overall assessment
Group accounts						

## Detailed findings on red and amber ratings

### Reclassification of fixed assets

#### Property, Plant and Equipment (PPE)

The Code requires authorities to account for PPE in accordance with IAS 16 *Property, plant and equipment*. PPE is defined in the Code as tangible assets that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and are expected to be used during more than one period.

The main areas of adjustment for the Council are noted below.

#### Investment Properties

The Code requires authorities to account for investment properties in accordance with IAS 40 *Investment properties*. The Code interprets IAS 40 by defining investment properties as those held solely to earn rentals and/or for capital appreciation, and not used to deliver services or for administrative purposes. This is a separate category from PPE, and is a tighter definition than the SORP.

In the restatement exercise, the Council has identified that it holds £1 million of investment properties, with reclassifications of £5.8 million of previously identified investment properties under UK GAAP. We have requested details on a sample of assets held for sale to ensure they comply with the requirements for classification in the Code.

#### Assets held for Sale

The Code requires authorities to account for assets held for sale in accordance with IFRS 5, *Non-current assets held for sale and discontinued operations*. As a new requirement from 2010/11, the Code requires assets to be classified as held for sale if their carrying amount will be recovered principally through a sale rather than their continued use. This is a separate category from PPE. There are a number of differences between the Code's requirements for assets held for sale and the broadly equivalent category of surplus assets under the SORP (which now is a sub-classification of PPE).

In the restatement exercise, the Council has identified that it holds £8.6 million of assets held for sale. We have requested details on a sample of assets held for sale to ensure they comply with the following requirements for classification in the Code:

- the asset must be available for immediate sale in its present condition
- the sale must be highly probable, which means management must be committed to a plan of sale, and an active programme to locate a buyer and complete the plan must have been initiated
- the asset must be actively marketed at a reasonable price
- the sale should be expected to be completed within one year of the classification.

### **Surplus Assets**

Assets classified as surplus assets under the SORP may also be classified as surplus assets within property, plant and equipment under the Code. This will arise where an asset does not meet the criteria to be classified as either held for sale or as an investment property for example where the asset is no longer used for service delivery but the authority has not, at the balance sheet date, decided whether to sell the asset or develop it. The asset requires to be valued at existing use rather than market value and CIPFA guidance recommends that the asset's last use in providing services should be used for this purpose.

Total surplus assets as at 1 April 2008 was £6.5 million. Our review noted the following significant surplus assets held by the Council following the restatement exercise:

- Toward Castle Outdoor School (£2.15 million)
- Ardentinny Outdoor Centre (£0.9 million)
- Lochgilphead Primary School (£1.5 million)
- Rockfield Primary School (£1.1 million).

We have requested supporting documentation for these assets to confirm they are correctly classified as surplus assets within the Property Plant and Equipment asset category.

We also noted that all surplus assets, with the exception of the two primary schools noted above, are valued at open market value and not existing use value. The Council's valuer has carried out a review of material assets within the surplus asset category and identified that only two assets (the outdoor centres) will have a significantly different value under an existing use valuation. As such an adjustment will be required for the opening balance for these assets, the Toward Castle Outdoor School will be transferred to assets held for sale in 2010-11.

### **Asset Register**

The Council is currently updating its asset register to incorporate the requirements of IFRS.

At the final accounts visit, we will review reconciliations of the opening balances, and 31 March 2010 figures to the asset register to ensure they are properly recorded within the ledger.

### **Componentisation**

Componentisation refers to the practice of separately identifying and depreciating two or more components of an asset. The Code requires that authorities define components that require to be depreciated separately in the context of those having a 'cost that is significant in relation to the total cost of the asset. This requirement takes effect from 1 April 2010.

The Council has not maintained records of asset components in previous years. Going forward, the Council plans to componentise assets in excess of £1 million. A threshold will be used whereby only components in excess of 20% of the value of the overall asset will be recognised. The Council will identify significant components by reviewing capital expenditure over £200,000 for specific projects. We have accepted this proposal as reasonable.

### **Trade and other payables**

#### **Holiday pay accrual**

A new requirement under the Code relates to the treatment of short-term accumulating compensated absences that can be carried forward where the current entitlement is not used e.g. annual leave and flexitime balances, as authorities are required to recognise a liability for the untaken element at the year end. Authorities are required to measure the additional amount that they expect to pay as a result of unused entitlement that has accumulated at the balance sheet date. This is required even where employees are not entitled to a cash payment for unused entitlement on

leaving. Authorities are required to gather information on the number of days of untaken leave as at 31 March to allow them to identify the liability. The liability should represent the proportion of the annual salary which relates to the number of days of untaken leave.

Like many other authorities, the Council has found practical difficulties in obtaining the information required to calculate an accurate holiday pay accrual, mainly due to a lack of central computerised records for all grades of staff. Accordingly the Council has adopted a methodology using a sample of 5% of employees. The sample is selected across a wide range of employees to ensure it includes all relevant grades and geographical locations. Additional work has been completed on teacher's holiday pay, and on staff groups where holiday balances are likely to be significant (eg those staff on maternity leave).

We have considered the methodology and found it to be sufficient for the purposes of calculating the holiday pay accruals. We intend to review the sample chosen by the Council to confirm the accuracy of the calculation as part of our financial statements audit.

### **Group Accounts**

The Code requires authorities to prepare group accounts in accordance with IFRS 3 *Business combination*, IAS 27 *Consolidated and separate financial statements*, IAS 28 *Investments in associates*, and IAS 31 *Interests in joint ventures*.

The Council has interests in five associates: Strathclyde Police Joint Board, Strathclyde Fire and Rescue Joint Board, Dunbartonshire and Argyll and Bute Valuation Joint Committee, Strathclyde Partnership for Transport, and Strathclyde Concessionary Fares Joint Committee.

The move to IFRS does change the basis on which an authority should recognise a subsidiary, associate or jointly controlled entity. The Council should perform a review to ensure it captures any other bodies that would fall within its group boundaries.

The presentation of the group accounts under IFRS is different from the accounts produced under UK GAAP. The Council are currently producing a draft set of group accounts, and we will review these in our final accounts visit in July 2011.

## Other findings

### **Accounting policies**

We have reviewed the Council's proposed IFRS accounting policies. The proposed accounting policies comply with the requirements of the Code, and are in line with our expectations based on our knowledge of the Council.

We note that there is no specific policy in place for financial assets. As the Council holds loans and receivables of £25 million as at 31 March 2010, we recommend that a policy on financial assets be included. The Council has agreed to review the need for including a policy for financial assets.

### **Segmental Reporting**

The Code requires authorities to comply with IFRS 8 *Operating segments* (as adapted by Code paragraph 3.4.1.6) and this is a new requirement from 2010/11. Reportable segments should be based on an authority's internal management reporting. A segment requires to be reported where: its expenditure is 10% or more of the gross expenditure within the net cost of services; or its income is 10% or more of the gross income. Disclosure of operating segments is in addition to the requirement to present the comprehensive income and expenditure statement on BVACOP basis.

A key issue for the Council in producing segmental reporting disclosures is that the significant restructuring of the management structure in 2009-10 will impact on the ability of the Council to provide comparative figures for operating segments. We have considered this approach and concluded it is reasonable based on the way the Council's ledger operates.

### **Common Good Funds**

The Council continues to administer the seven common good funds for the former burghs within the Argyll and Bute area. Whereas the SORP required authorities to disclose details of the nature and amount of these funds, there is no similar Code requirement. However the Council should continue to comply with LAASAC guidance note, Accounting for the Common Good Fund: A guidance note for practitioners.

The Oban Common Good Fund is also a registered charity under the Charities and Trustee Investment (Scotland) Act 2005. As such, separate statutory accounts are prepared for this Fund under the requirements of the Charities Accounts (Scotland) Regulations 2006, which requires the Fund to comply with the Charities SORP.

We recommend that the Council include a disclosure in the Common Good Funds note indicating the accounting basis for each Fund.

In addition, the Council should review the potential requirement and impact of IFRS adjustments for those Funds which are not registered charities in relation to consolidation for the group accounts.

### **Embedded leases**

The Council has established plans to carry out a review of expenditure items as part of the process to identify any embedded lease contracts. This will include a full review of all service level agreements held by the Council. We will review the outcome of this review at our final accounts visit.

## Overall conclusions and recommendations

The results of our work indicate that the Council's overall arrangements for IFRS restatement have been adequately planned, focusing its resources on the key risk areas.

Overall at this stage we are content that the processes undertaken by the Council have enabled management to highlight the accounting, explanatory, and presentational adjustments required for restatement to IFRS. Understandably there is more work to do and we will be working closely with the Finance team in their preparation of fully IFRS accounts for 2010/11.

	<b>Finding</b>	<b>Recommendation</b>	<b>Management Response</b>
1	<p><b>Employee benefits</b></p> <p>The Council's current systems for recording flexitime and holidays do not allow real time capture of relevant balances on an individual employee basis at the balance sheet date.</p>	<p>The Council should consider improvements to the systems for recording employee flexitime and holidays to improve the accuracy of the year end employee benefits accrual.</p> <p>We are aware that upgrades to the Resourcelink system may allow such a functionality to be available in future years.</p>	<p>The upgrade to Resourcelink should allow the Council to calculate the flexitime and holiday pay accrual accurately in the future.</p>
2	<p><b>Group accounts</b></p> <p>The Council has produced group accounts for 2009-10 under IFRS, but has not yet finalised the layout of the group accounts within the financial statements.</p> <p>The changes in the Code increase the risk that bodies that fall within the group</p>	<p>The layout of the group accounts should be finalised and presented for review.</p> <p>The Council should ensure a full review is completed that identifies any other bodies that fall within the group boundary.</p>	<p>Layout finalised and presented for review.</p> <p>No further bodies have been identified which fall within the group boundary.</p>

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	Finding	Recommendation	Management Response
	boundary are not consolidated.		
3	<p><b>Common Good Funds</b></p> <p>The Council has seven Common Good Funds in the area, of which one is a registered charity and separate accounts prepared under the Charities SORP.</p>	<p>The Council should consider disclosure requirements for the Common Good Funds in the 2011 IFRS financial statements.</p> <p>The Council consider if there is a need for any IFRS adjustments for the Funds in order to facilitate consolidation into the Group accounts.</p>	<p>This will be considered when the group accounts are being prepared.</p>
4	<p><b>Surplus assets</b></p> <p>The Code requires surplus assets held within PPE to be valued at existing use (at the time the asset was last operational). The current valuation method for these assets in the asset register is market value. The Council has identified significant asset values for review to ensure there is no material difference in the valuation methods.</p>	<p>The value of surplus assets in PPE should be assessed to determine they are compliant with the Code.</p> <p>Surplus assets should be valued at existing use, any material differences to the value should be processed through the opening balance sheet and the balance sheet as at 31 March 2010.</p>	<p>A review has been performed and it has been ascertained that in the majority of instances there is not a material difference between market value and existing use value.</p> <p>Where material differences have occurred the difference in value has been processed through the opening balance sheet at 1<sup>st</sup> April 2009.</p>



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