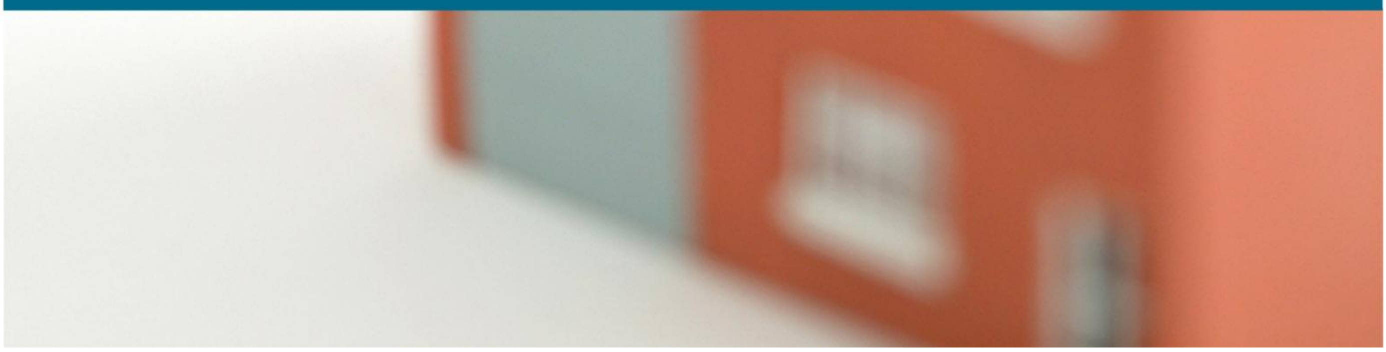
Falkirk Council

Report on Restated IFRS Opening Balance Sheet & PFI Adjustments

April 2011

AUDIT SCOTLAND



Contents

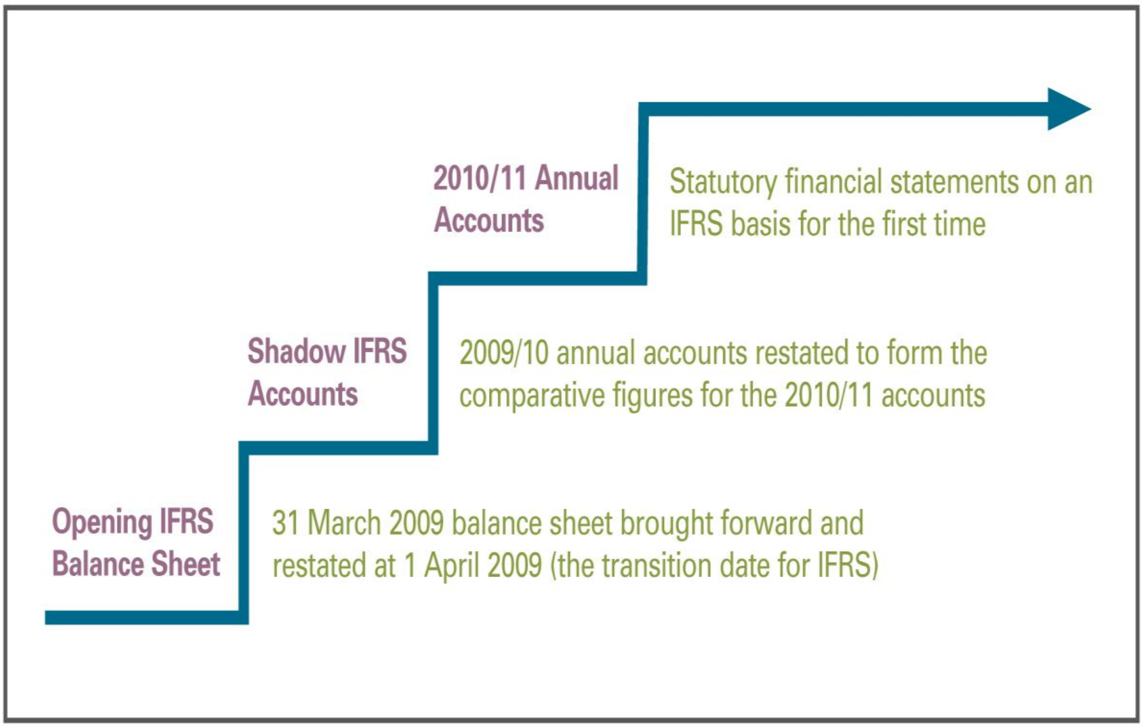
Introduction

1. As announced by the Chancellor in the 2008 Budget Report on 12 March 2008 (Budget Report paragraph C103), Government departments and other public sector bodies will report using International Financial Reporting Standards (IFRS) from 2009/10. The introduction of IFRS for public sector financial reporting is perhaps the biggest challenge that accountants and auditors have had to face in recent years, with a series of complex and resource intensive changes in accounting policy required.

2. In local government, IFRS based changes for financial instruments were introduced in 2007/08. The financial statements for 2009/10 incorporate further IFRS-based changes in respect of Private Finance Initiative (PFI) accounting. Full IFRS compliance is required for the 2010/11 accounts and the opening IFRS balance sheet is the first step towards the production of these accounts.

Exhibit 1 Key IFRS transition milestones

The early production of an opening IFRS balance sheet is the key to a smooth IFRS transition



Source: Audit Scotland

Timetable

3. There is no formal deadline in advance of 30 June 2011 for the production of the opening IFRS balance sheet and shadow accounts. However, it is acknowledged good practice to start work on these restatement exercises as early as possible to provide sufficient time to accommodate the work required.

4. In line with this good practice, Falkirk Council requested that we review their opening balance sheet in advance of our audit of the 2010/11 financial statements. This report includes our findings from that review. The issues raised should be considered going forward as the council prepares its fully compliant IFRS financial statements in 2010/11.

5. Falkirk Council has assisted CIPFA in 'road-testing' a transition template spreadsheet which converts the 2009-10 GAAP Accounts to IFRS Accounts. The 'road-test' of the transition template spreadsheet was completed by Falkirk Council in August 2010. CIPFA subsequently rolled out this spreadsheet to all Scottish local authorities with a deadline for the completion of the document of 15 October 2010. Subsequent meetings were held between the council and CIPFA to review and agree the content of the Falkirk Council submission.

Scope of Audit Work

6. This review of opening balances is limited to the single entity opening IFRS balance sheet and does not cover the accounting policy disclosures; the notes to the accounts; the group accounts and pension fund statements. However, we did review the preparations the council has made to move towards IFRS-compliant group and pension fund accounts.

7. In carrying out the review of the restated IFRS balance sheet, we reviewed the presentation of the balance sheet and supporting documentation. This exercise involved reviewing high risk items and assessing whether expected adjustments had been made and whether sufficient evidence had been provided. The high risk items include:
   - employee benefits accruals
   - PFI / PPP accounting
   - changes in the classification and valuation of fixed assets
   - leases classifications
   - the treatment of government grants deferred.

Main Findings

8. Overall the council has made good progress to date in the transition to implementing IFRS. The council prepared their revised opening Balance Sheet in February 2010 and this was sent to CIPFA/PwC for quality review purposes. Correspondence between CIPFA/PwC and the council resulted in changes to the reclassification of some Assets for Sale, reclassification of capital grants which were developers contributions, and the reversal of the assumed statutory mitigation for Northfield Quarry finance lease income. All adjustments were subsequently made by the council and restated IFRS statements prepared and submitted to CIPFA prior to the stated deadline.

9. Findings from our review are noted in the following paragraphs. Further work will now be required to ensure that the shadow IFRS accounts for 2009/10 and the full IFRS accounts for 2010/11 show a true and fair view.

Employee benefits accruals

10. Under IFRS, organisations are required to provide for liabilities from employee benefits payable at the balance sheet date. This can include items such are untaken annual leave and flexitime.

11. The council established the non-teaching staff accrual on a sample basis. The sample included 10% of non-teaching staff and all 26 chief officers.

12. The teachers' short term employee benefits accrual excludes maternity leave. Following changes to teachers' maternity leave regulation in 2008, employees on maternity or adoption leave are now entitled to accrue their annual leave and public holidays during the entire leave period.

13. In May 2010, the conditions under these regulations changed to provide for 66 days annual leave for teachers on maternity leave for a full year. Falkirk Council has implemented the revised conditions for individuals who returned from maternity leave on or after 21 May 2010 but has taken a decision not to implement them for employees who returned to work on or before 20 May 2010. As a consequence of this decision, 12 outstanding Tribunal claims are being considered with an estimated value of £0.08m. This matter is being considered at a test case which has still to be arranged.

14. CIPFA conducted a reasonableness check of the employee benefits accrual for both teaching and non-teaching staff. The result of their review concluded that Falkirk Council's accrual was within the parameters of reasonableness.

Leases

15. The revised IFRS code requires that a range of criteria be considered when evaluating how a lease should be categorised, including a present value criterion. The council has used this as the key determinant of whether a finance lease exists.

16. Falkirk Council decided to only examine leases where the authority is the lessee over the value of £50K per annum for the purposes of determining whether they were operational or financial in nature. The council intends to review the remaining leases on a rolling basis. A sample of 7 leases, with a total annual payment of £1,036K (32% of annual leave payments in 2009/10), was reviewed and all leases were categorised as operational.

17. Two significant leases, Northfield Quarry and Window Leases, were reviewed separately and these were reclassified as finance leases resulting in restated balances.

18. In addition, 3 leases receivable were reviewed (12% of total income received in 2009/10) and these were all classified as operational in nature.

19. The impact of lease incentives was undertaken. A sample of 12 leases from 2009/10 leases was tested and the sample revealed an extrapolated accrual of £56K. This was not considered material and therefore an adjustment to the restated balance sheet was not required. The Principal Surveyor has agreed to provide Finance with details of a lease incentive for every applicable transaction from 2010/11 onwards therefore a sampling exercise of this nature will not be required in the future.

20. The council monitors lease income through its Propman system and a spreadsheet is used to monitor leases payable. The council is considering procuring an asset management system which would include leases.

Private Finance Initiative (PFI)

21. A key component of the change to International Financial Reporting Standards was the early adoption (in 2009/10) of the Standards relating to PFI and PPP projects (or service concession arrangements). Practically, for most Scottish PFI/PPP projects, the new rules bring the assets and liabilities associated with these projects onto the balance sheet.

22. The council has signed two PFI contracts with different operators. These contracts are for:

    - five schools operated by Class 98 Ltd. This was one of the first such contracts in Scotland and the schools have been operational sine August 2000.

- four schools operated by Falkirk Schools Gateway Limited under a Non-Profit Distribution Organisation (NPDO) arrangement. These schools became operational on a phased basis from January 2009.

23. We have reviewed the council's accounting entries for PFI as at 31 March 2009 as well as the assumptions used in calculating those accounting entries. Based on our work performed, we have a number of observations which are listed below.

24. The council has taken the view that estimated lifecycle costs below £100,000 are revenue maintenance costs, and lifecycle costs greater than £100,000 should be capitalised and depreciated over 20 years. However, a risk to this approach is that the council will be capitalising costs without knowing whether this was incurred, what it represents or whether it qualifies as a fixed asset or an enhancement of an existing asset. Up to 31 March 2009, the council has capitalised £625,867 of lifecycle costs.

25. When component accounting is introduced in 2010/11, the council will be required to account separately for any significant elements of assets that have different economic lives to the main asset. Under component accounting, assets being replaced require to be derecognised. There is a risk that the council's current treatment of lifecycle costs will not be compatible with component accounting under IFRS.

Refer action plan no 2

26. For the Class 98 PFI contract, "plant included in construction cash flows" of £23.158 million has been excluded from the fixed asset construction cost. The council assumed that this did not form part of the fabric of the building but definitive clarification had not been received from the Class 98 operator. If this did in fact relate to the fabric of the building that was later revalued, the revaluation reserve would be overstated and assets understated.

Refer action plan no 3

27. The Accounting Model does not write off the liability to £nil, as a balance of -£2,434,330 remains as at 03/2030. This would imply that there is an error in the Accounting Model. We noted one error in respect of the accounting entries as at 31 March 2009, relating to the carrying value and revaluation reserve entries for the Class 98 schools which are both overstated by £16,000. In addition, the gross book value and accumulated depreciation figures for these schools were overstated by £11,574,000 and £11,558,000 respectively. These latter balances have subsequently been amended during the 2009/10 financial statements audit.

Refer action plan no 4

Presentational Issues

28. Presentational issues were also noted as part of our review as follows:

- headings for 'Deferred Tax Asset', 'Current Tax Asset', 'Current Tax Liability' and 'Deferred Tax Liability' are only required for the Group Balance Sheet

- the 'Available for Sale Financial Instruments Reserve' was disclosed within Usable Reserves, this should be included within Unusable Reserves.

Refer action plan no 5

Conclusion

29. The Council adopted a proactive approach to the adoption of IFRS which resulted in the preparation of the restated opening balance sheet and supporting documentation prior to the submission of the 2009/10 draft accounts.

30. The issues identified in preparing this report are only those which have come to our attention during the course of the review and are therefore not necessarily all the issues that may exist. An action plan has been prepared at Appendix A.

Looking forward

31. The full set of shadow 2009/10 accounts requires further IFRS disclosures. This includes income and expenditure, group accounts, notes to the main financial statements and associated policies. Shadow accounts for 2009/10 have recently been received and we intend to review them in May 2011.

32. Formal IFRS based accounts will be required in 2010/11. Continued progress will be required in the coming months to prepare for this first year of full IFRS accounts.

33. We will continue to monitor the council's progress in moving towards full IFRS implementation.

Acknowledgements

34. The assistance and co-operation we received during the course of our audit is gratefully acknowledged.

Appendix A: Action Plan

Action Point	Issue and Risk	Response and Agreed Action
1	The council has taken the view that estimated Private Finance Initiative (PFI) lifecycle costs below £100,000 are revenue maintenance costs and lifecycle costs greater than £100,000 should be capitalised and depreciated over 20 years. However, a risk to this approach is that the council will be capitalising costs without knowing whether this was incurred, what it represents or whether it qualifies as a fixed asset or an enhancement of an existing asset. Up to 31 March 2009, the council has capitalised £625,867 of lifecycle costs. When component accounting is introduced in 2010/11, the council will be required to account separately for any significant elements of assets that have different economic lives to the main asset. Under component accounting, assets being replaced require to be derecognised. ***Risk: the council's current treatment of lifecycle costs will not be compatible with component accounting under IFRS.***	*We have now changed our view on the treatment of lifecycle costs. The scheme operator (Class 98) has refused to tell us both what the lifecycle costs represent in their model documentation and what they are spending on an ongoing basis. With that in mind we have now decided that no such costs will be capitalised in the future. There will therefore not be an issue with component accounting.*
2	For the Class 98 PFI contract, "plant included in construction cash flows" of £23.158 million has been excluded from the fixed asset construction cost. The council assumed that this did not form part of the fabric of the building but definitive clarification had not been received from the Class 98 operator. ***Risk: if this did in fact relate to the fabric of the building that was later revalued, the revaluation reserve would be overstated and assets understated.***	*As above, Class 98 has refused to tell us what this cost represented. It was therefore decided that this cost would not be capitalised.*
3	We noted one error in respect of the accounting entries as at 31 March 2010, relating to the carrying value and revaluation reserve entries for the Class 98 schools which are both overstated by £16,000. In addition, the gross book value and accumulated depreciation figures for these schools are overstated by £11,574,000 and £11,558,000 respectively. These latter overstatements have been subsequently amended. ***Risk: Class 98 carrying values are incorrectly stated as at 31 March 2009.***	*The Class 98 accounting entries have all been restated and audited as part of the 2009/10 Final Accounts process and therefore reflect the correct carrying value of the assets i.e. the overstatements of circa £11m have been corrected. The £16k is not material and has not been investigated further.*

Action Point	Issue and Risk	Response and Agreed Action
4	Minor Presentational issues were noted as part of our review. ***Risk: Accounts may not be presented in accordance with International Financial Reporting Standards.***	*These have now been addressed. In addition our consultants, as well as ourselves will be carrying out a review of, presentational issues among other things, prior to the 2010/11 accounts being submitted.*