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IFRS restatement of 2009/10 accounts

Carlisle City Council

Audit 2010/11

audit commission

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Introduction

1 Carlisle City Council's financial statements for 2010/11 will be based on the International Financial Reporting Standards (IFRS).

2 The Government's motivation for the move to IFRS reporting in the public sector was stated in the 2007 Budget. He said change is necessary 'to bring benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice.'

3 In preparation for this change, councils must restate their 2009/10 accounts on an IFRS basis. This is because these figures become the prior year comparative figures in the 2010/11 statement of accounts. The restatement exercise requires the Council to review and change the opening balance sheet at 1 April 2009, the closing balance sheet at 31 March 2010 and the Income and Expenditure Account for 2009/10.

4 I need to review the restated figures in order to gain assurance over the comparative figures included in the 2010/11 accounts. This forms part of my audit opinion work for 2010/11.

Audit approach

5 I have discussed the restatement exercise with officers to gain an understanding of the factors affecting it. This helps me to identify and assess the risk of the restatement not being properly compiled and adjustments being inappropriate. I also need to consider whether the financial information (as restated) is consistent in all material respects with the Code of Practice on Local Authority Accounting 2010/11 (based on IFRS).

6 For this exercise, I have determined materiality in the same way I would set it for the audit of the financial statements.

7 The following section of this report summarise the main conclusions arising from the work I have undertaken on your restated 2009/10 financial statements based on the Code of Practice on Local Authority Accounting 2010/11.

8 However, my report does not cover tangible fixed assets as the IFRS code has not been applied retrospectively to this part of the balance sheet. This means these assets do not need to be restated.

9 International Accounting Standard 16 (IAS16) requires tangible assets be analysed into their significant component parts and valued on the basis of these components. 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.

Such components need to be recognised, depreciated and derecognised separately from the asset as a whole from 1 April 2010. Work is ongoing across the Council to identify the significant components and to capture the relevant valuation information.

10 The following section of this report summarise the main conclusions arising from the work I have undertaken on your restated 2009/10 financial statements based on the Code of Practice on Local Authority Accounting 2010/11.

11 The number of issues identified has meant this work has taken considerably longer than expected. It is likely that I will need to revisit the audit fee for 2010/11 to reflect the additional work that I have had to undertake.

Main conclusions

Overall findings

12 The Council produced a set of skeleton 2010/11 accounts in line with CIPFA guidance. Skeleton accounts in this context means a set of 2010/11 accounts containing all the required statements, notes and disclosures with the 2009/10 comparative figures included.

13 I reviewed the Council's skeleton accounts which include the 2009/10 restated figures. I found the Council had made good progress and had produced comprehensive working papers to support the restated figures. However, there are some significant areas where further consideration and justification of the treatment adopted by the Council is required. The most significant matters are outlined below with a full list of the issues shown at appendix 1.

Significant issues management need to address in advance of the 2010/11 audit

Leases

14 The Council undertook an exercise to identify all its leases and considered whether they need to be reclassified (operating lease to finance lease and vice versa) under the terms of International Accounting Standard (IAS)17.

15 The Council has a large number of leases (nearly a thousand) in which it acts as lessor. In its reclassification exercise it has classed just one of these as a finance lease.

16 The primary indicators which may collectively or individually provide evidence of a finance lease under IAS 17 are:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value so as to make it reasonably certain the option will be exercised;
- the lease term is for the major part of the economic life of the asset;
- the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

17 I reviewed the Council's lease database and believe some leases require further investigation to determine whether they should be treated as finance leases under IAS17.

18 There are over 200 industrial estate leases which bring in an annual rental of £1.8 million. There are also a further 17 industrial estates on which the Council received upfront premiums of £5.2 million. Our audit identified a further upfront payment of £1.3 million not included within the initial analysis. These leases are for 99 years or more in most cases. The Council considers these to be land leases and has treated them as operating leases. There was a presumption under IAS17 that land leases must be operating leases but the Practitioners' Guide points out that 'the Code adopts the amendment to IAS 17 (introduced by the IASB's Annual Improvements 2009) which removes the presumption that land is normally an operating lease. Therefore the land and buildings classifications should be determined based on the substance of the lease and applying the indicators above. In doing so, the Code notes that land normally has an indefinite economic life. However, the longer the term of the lease, the less certain an authority can be that this presumption will hold, and it is open for practitioners to conclude that land elements are finance leases, even where title will not transfer.'

19 It is likely that the net present value (NPV) of minimum lease payments on some leases will be equivalent to the fair value of the land. Given this condition may be met in some cases, the Council needs to give further consideration to whether some of these leases should be classified as finance leases.

20 In addition to the industrial estate leases highlighted above, my review identified other leases where the Council needs to provide further justification for classifying as operating leases. They are:

- land at Whinnie House Road (£6,250k pa for 99 years);
- Asda, Chandler Way (£440k pa for 150 years);
- two Currock Road Retail Park leases (£58k pa for 125 years and £20k pa for 99 years); and
- Durranhill (£6,000k pa for 5 years then £30,000 pa for 120 years).

Accounting entries

21 The Council is treating leases where it has received an upfront capital premium as operating leases. I have recommended that the Council provide further justification for this classification.

22 If the Council's treatment of these leases as operating leases is correct, it will need to revisit the accounting treatment it has adopted. The Council has set up a deferred capital receipt for the up front sums received and this is being released to revenue over the lifetime of the leases. As all income from operating leases is revenue, it is incorrect to treat it as a deferred capital receipt and it should instead be shown as deferred income.

23 Where the Council received an upfront premium it wrote the assets out of the balance at that time. The Council has brought these assets back onto the balance sheet based on its treatment of these as operating leases. However, it then re-valued these to nil as they believed they were already on the balance sheet and had continued to be revalued as part of a larger piece of land. This is confusing and the Council needs to clarify whether these assets have been included in subsequent revaluations or not.

Capital grants receipts in advance

24 Capital grant receipts in advance of £3,180k in the 2009/10 Balance Sheet includes NWDA grant of £952k for the purchase of Adriano's and 8 Warwick Street; and £1,518k in respect of NWDA grant for Durranhill acquisition and demolition.

25 Grants and contributions for capital purposes must be recognised immediately, unless any conditions have not been met. I am not aware of any outstanding conditions on the Durranhill grant as qualifying expenditure had been defrayed by the year-end. In the case of Adriano's and Warwick Street repayment is likely but the grant should have been initially recognised in the Comprehensive Income and Expenditure Statement (CIES) and a liability should not be recognised until a return obligation arises. I do not consider there was an obligation to repay as at 31 March 2010 although it may have arisen since then.

Disclosure requirements

26 I identified several areas in which the Council's skeleton statements do not comply with the Code disclosure requirement. These issues were individually minor but will need to be addressed in the final statements. They include:

- incorrect analysis of lease payments and receipts;
- inadequate analysis of where impairments and revaluation gains and losses were charged; and
- incomplete information on investment properties.

27 A full list of the areas of non-compliance with the Code is provided at appendix 2. A CIPFA disclosure checklist is now available for 2010/11 and the Council should complete this as part of it closedown and quality assurance arrangements.

Appendix 1 Issues to be addressed

<table>
<tr><th>Issue</th><th colspan="2">Recommendation</th><th>Value</th></tr>
<tr><td colspan="4">Opening Balance Sheet at 1 April 2009</td></tr>
<tr><td>Industrial estates with annual rental of £1.8m have been deemed land leases and treated as operating leases. The Code adopted the amendment to IAS 17 (introduced by the IASB's Annual Improvements 2009) which removes the presumption that land is normally an operating lease. There are industrial estates with long leases of 99 years and over in most cases.</td><td>R1</td><td>Reconsider the classification of land leases with annual rentals by reference to the Code criteria.</td><td>Not known.</td></tr>
<tr><td>The Council is lessor for a number of land leases where it received upfront premiums amounting to £6.5m and which were treated as capital receipts. These have been reclassified as operating leases and a deferred capital receipt set up.</td><td>R2</td><td>Reconsider the classification of land leases with upfront premiums by reference to the Code criteria. If still considered to be operating leases revise accounting treatment as operating leases cannot generate a deferred capital receipt.</td><td>Not known</td></tr>
<tr><td>Where the Council has received an upfront premium it has written the asset out of the balance sheet. However, one of the Council's working papers suggests these assets may have been incorrectly included in subsequent valuations.</td><td>R3</td><td>Clarify whether assets, where the Council has received an upfront premium, have been included within subsequent valuations.</td><td>Not known</td></tr>
<tr><td>The following leases were not reclassified by the Council but I believe they may warrant further investigation to determine whether they meet the Code criteria for finance leases.
■ Land at Whinnie House Road (£6,250k pa for 99 years)
■ Asda, Chandler Way (£440k pa for 150 years)
■ 2 x Currock Road Retail Park (£58k pa for 125 years and £20k pa for 99 years)
■ Durranhill (£6k pa for 5 years and then £1120k pa for 120 years).</td><td>R4</td><td>Reconsider the classification of these specific leases (Land at Whinnie Road, Asda, Currock Road Retail Park and Durranhill) by reference to the Code criteria.</td><td>£9,315k</td></tr>
</table>

Issue	Recommendation	Value
£952k of NWDA grant in respect of Adriano's and 8 Warwick Street which was in government grant deferred has been treated as a capital grant receipt in advance on the 2008/09 restated balance sheet. I would expect the full balance on government grant deferred to be written off to the CAA as specified in the Code.	**R5** Write off NWDA grant in respect of Adriano's and Warwick Street to the CAA. Recognise a liability only when the obligation to repay arises.	£952k
The Council has not split provisions between current and non-current. All have been disclosed as long-term liabilities. As at 1 April 2009 the major part of the provisions was job evaluation backpay provision of £1,362k which was utilised in 2009/10 so should be treated as a current liability.	**R6** Analyse provisions between current and non-current on the face of the Balance Sheet.	£2,192k
Land at Low Meadow and land at Gelt Rise has been classified as non-current assets held for sale with a value of £530k. The properties may not meet the IFRS criteria for non-current assets held for sale.	**R7** Review the basis of classification and valuation of non-current assets held for sale with reference to the Code criteria.	£530k
Closing Balance Sheet at 31 March 2010		
The Balance Sheet at 31 March 2010 includes capital grants receipt in advance of £1,518k NWDA grant for Durranhill. It is unclear what conditions are deemed to be outstanding at the Balance Sheet date.	**R8** If no grant conditions are outstanding on the Durranhill grant, recognise the grant in the CIES and transfer to the CAA.	£1,518k
Movement in Reserves Statement (MiRS)		
The supporting notes to the MiRS do not fully analyse the movements shown in the main statement.	**R9** Revisit the supporting notes to the MiRS and ensure that these fully analyse the adjustments between accounting basis and funding basis under regulations.	Not applicable

Issue	Recommendation	Value
Cash flow statement		
An adjustment of £561k to the Cash Flow Statement in respect of government grants has been treated as a non-cash movement. It should be split as £1,800k credit to 'Adjust net surplus or deficit on the provision of services for non cash movements' (relates to grant amortisation) and £2,361k debit to 'Adjust for items included in the net surplus or deficit on the provision of services that are investing and financing activities' (relates to capital grant received).	**R10** Split the adjustment to the Cash Flow Statement in respect of government grants between grant amortisation and receipt of capital grant. These adjustments should be made to 'Adjust net surplus or deficit on the provision of services for non cash movements' and 'Adjust for items included in the net surplus or deficit on the provision of services that are investing and financing activities' respectively.	£2,361k
Lease receipts of £40k in respect of leases with upfront premiums have been adjusted through 'Adjust for items included in the net surplus or deficit on the provision of services that are investing and financing activities' in the Cash Flow Statement. This is a notional receipt and should be adjusted through 'Adjust net surplus or deficit on the provision of services for non cash Movements'	**R11** Adjust for notional lease receipts in the 'Adjust net surplus or deficit on the provision of services for non cash Movements' line of the Cash Flow Statement.	£40k
No working paper was available to support the note to the Cash Flow Statement on investing and financing activities.	**R12** Produce a working paper showing the derivation of all figures in the cash flow note on investing and financing activities.	Not applicable
Presentation and disclosure		
The skeleton accounts do not fully comply with the Code in terms of presentation and disclosure. Specific details are provided at appendix 2.	**R13** The accounts should be revised to take account of Code requirements. A CIPFA disclosure checklist is available and should be completed as part of the Council's closedown and quality assurance arrangements.	Not applicable

Appendix 2 Code of Practice non-compliance

Disclosure Issues

The table below shows areas of non-compliance with the Code of Practice on Local Authority accounting.

Code ref	Issue
3.4.2.43	CIES includes a line 'Surplus or deficit on revaluation of property, plant and equipment assets.' This should be 'surplus or deficit on revaluation of non-current assets.'
3.4.2.53	Assets held for sale have been incorrectly included within Current Assets on the Balance Sheet.
3.4.2.53	Stock should be disclosed as inventories on the Balance Sheet.
3.4.2.53	The pension liability should be disclosed as 'Other long term liabilities'
3.4.2.78	The section in Accounting Policies on accounting estimates and judgements should be expanded.
3.4.2.79	No need for accounting policy on PFI as not relevant to the Authority.
4.1.4.4	PPE note does not include a sub-category of furniture and equipment.
4.2.4.2	Lease note does not disclose for each class of asset held under finance lease (ie Denton Holme) the total of future minimum lease payments at the Balance Sheet date, and their present value, for each of the following periods: not later than one year; later than one year and not later than five years; and later than five years.
4.2.4.2	Lease note does not disclose the total of future minimum lease payments made by Authority under non-cancellable operating leases for each of the following periods: not later than one year; later than one year and not later than five years; and later than five years.
4.2.4.2	Lease note does not disclose, for operating leases where the Authority is lessor, the present value of minimum lease payments receivable at the Balance Sheet date, for each of the following periods: not later than one year; later than one year and not later than five years; and later than five years.
4.7.4.2	Greater analysis of impairments and where charged is required.
5.1.4.2	Authority has not disclosed the amount of inventories recognised as an expense during the period.
3.9.4.1	Related Party note does not disclose amounts of transactions and outstanding balances.

Appendix 3 Action Plan

Recommendations	
Recommendation 1	
Reconsider the classification of land leases with annual rentals by reference to the Code criteria.	
Responsibility	Chief Accountant
Priority	High
Date	30 June 2011
Comments	Consideration has been given to the leases identified and they have been deemed to fall within the definition of an Operating Lease meaning that the treatment shown in the Accounts and Restatement is correct. Although the leases may pass the Net Present Value test, they fail the other 4 tests of a finance lease and also fail the additional 3 tests if there is any doubt over the first 5 tests. This treatment is still to be audited.
Recommendation 2	
Reconsider the classification of land leases with upfront premiums by reference to the Code criteria. If still considered to be operating leases revise accounting treatment as operating leases cannot generate a deferred capital receipt	
Responsibility	Chief Accountant
Priority	High
Date	30 June 2011
Comments	Reconsidered and reclassified as Finance Leases as they transfer risks and reward of ownership to lessee.
Recommendation 3	
Clarify whether assets, where the Council has received an upfront premium, have been included within subsequent valuations.	
Responsibility	Chief Accountant
Priority	High
Date	30 June 2011
Comments	Assets have been checked against valuations and found to have been excluded from the valuations.

Recommendation 4

Reconsider the classification of these specific leases (Land at Whinnie Road, Asda, Currock Road Retail Park and Durranhill) by reference to the Code criteria.

Responsibility	Chief Accountant
Priority	High
Date	30 June 2011
Comments	Examination of the leases has determined that these remain as operating leases. See Recommendation 1 for further information.

Recommendation 5

Write off NWDA grant in respect of Adriano's and Warwick Street to the CAA. Recognise a liability only when the obligation to repay arises.

Responsibility	Chief Accountant
Priority	High
Date	30 June 2011
Comments	Agreed and actioned.

Recommendation 6

Analyse provisions between current and non-current on the face of the Balance Sheet.

Responsibility	Chief Accountant
Priority	Medium
Date	30 June 2011
Comments	Agreed and actioned.

Recommendation 7

Review the basis of classification and valuation of non-current assets held for sale with reference to the Code criteria.

Responsibility	Chief Accountant
Priority	Medium
Date	30 June 2011
Comments	Agreed and actioned.

Recommendation 8

If no grant conditions are outstanding on the Durranhill grant, recognise the grant in the CIES and transfer to the CAA.

Responsibility	Chief Accountant
Priority	Medium
Date	30 June 2011
Comments	Agreed and actioned.

Recommendation 9

Revisit the supporting notes to the MiRS and ensure that these fully analyse the adjustments between accounting basis and funding basis under regulations.

Responsibility	Chief Accountant
Priority	High
Date	30 June 2011
Comments	Agreed and actioned.

Recommendation 10

Split the adjustment to the Cash Flow Statement in respect of government grants between grant amortisation and receipt of capital grant. These adjustments should be made to 'Adjust net surplus or deficit on the provision of services for non cash movements' and 'Adjust for items included in the net surplus or deficit on the provision of services that are investing and financing activities' respectively

Responsibility	Chief Accountant
Priority	Medium
Date	30 June 2011
Comments	Agreed and actioned.

Recommendation 11

Adjust for notional lease receipts in the 'Adjust net surplus or deficit on the provision of services for non cash Movements' line of the Cash Flow Statement.

Responsibility	Chief Accountant
Priority	Medium
Date	30 June 2011
Comments	Agreed and actioned.

Recommendation 12

Produce a working paper showing the derivation of all figures in the cash flow note on investing and financing activities.

Responsibility	Chief Accountant
Priority	Medium
Date	30 June 2011
Comments	Agreed and actioned.

Recommendation 13

The accounts should be revised to take account of Code requirements. A CIPFA disclosure checklist is available and should be completed as part of the Council's closedown and quality assurance arrangements.

Responsibility	Chief Accountant
Priority	Medium
Date	30 June 2011
Comments	Agreed

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