INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

West Dunbartonshire Council

CIPFA / LASAAC Code shadow financial statements 2008-09 and 2009-10
Audit: Year ending 31 March 2011

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AUDIT

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About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the *Code of Audit Practice*").

This report is for the benefit of West Dunbartonshire Council and is made available to the Accounts Commission and Audit Scotland (together "the beneficiaries"), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes, but that we have not taken account of the wider requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scope and objectives section of this report.

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Introduction

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice*.

Background

Local authorities have a duty under section 12 of the Local Government in Scotland Act 2003 to observe proper accounting practices. The Code of Practice on Local Authority Accounting in the United Kingdom 2010-11 ("the Code") constitutes proper accounting practice for the purposes of section 12 and therefore West Dunbartonshire Council ("the Council") is required to comply with the Code when preparing their financial statements.

The 2010-11 Code is the first to be based on International Financial Reporting Standards ("IFRS"), and has been developed by the CIPFA / LASAAC Code board under the oversight of the Financial Reporting Advisory Board ("FRAB"). The Code is based on approved accounting standards issued by the International Accounting Standards Board ("IASB") and interpretations of the International Financial Reporting Interpretations Committee ("IFRIC"), except where these are inconsistent with specific statutory requirements. The Code also draws on approved accounting standards issued by the International Public Sector Accounting Standards Board and the UK Accounting Standards Board where these provide additional guidance.

The Code is based on the following hierarchy of standards:

- IFRS (including international accounting standards and IFRIC and Standing Interpretations Committee interpretations) as adopted by the European Union;
- international public sector accounting standards; and
- UK generally accepted accounting practice ("UK GAAP").

Transition arrangements

The Council is required to account for the transition to the IFRS-based Code in accordance with IFRS 1 *First-time Adoption of International Financial Reporting Standards*, except where interpretations or adaptations to fit the public sector are detailed in the Code.

Accounting policy changes arising out of the adoption of the IFRS-based Code are to be accounted for retrospectively unless the Code requires an alternative treatment.

The Council is required to present an opening balance sheet as at 1 April 2009 and re-state the balance sheet and income and expenditure account comparative amounts as at 31 March 2010 ("the shadow financial statements").

Responsibilities

The purpose of this exercise is to review the opening balance sheet as at 1 April 2009 and the 2009-10 (re-stated) shadow financial statements and bring to your attention any matters that might prevent the figures being used appropriately for the first set of IFRS based financial statements for 2010-11. This review of the shadow financial statements does not constitute a full audit; the formal audit opinion will be given on the first full set of IFRS based financial statements for 2010-11. For clarity, this exercise has no implications for the 2009-10 statutory financial statements prepared under UK GAAP, as interpreted by the SORP.

It is the responsibility of the Council, chief executive and the section 95 officer to ensure that appropriate adjustments are made to the shadow financial statements based on the findings from this review, as required.

The shadow financial statements and supporting documentation were received by KPMG on 7 March 2011.

We have reviewed the opening balance sheet as at 1 April 2009 and the 2009-10 shadow financial statements and supporting documentation. The review consisted of:

- examining the accounting policies developed in response to the Code and assessing if all the changes in policy required have been made;
- reviewing items where there was a greater risk of potential for misstatement and assessing whether sufficient evidence has been provided to support either no change (when compared to a UK GAAP basis) or the new treatment – this includes changes in the valuation of tangible and intangible non-current assets, finance leases, capital grants and employee benefits accruals;
- for each change in accounting treatment, examining the reconciliation from UK GAAP, as interpreted by the SORP to the Code, on a sample basis where appropriate;
- for each reclassification or accounting change, examining those reclassifications for both correctness and completeness; and
- considering whether all the required disclosures have been made.

The following table summarises management progress and identifies areas requiring further work to ensure that the IFRS-based Code financial statements are "true and fair".

IFRS 5 Non-current assets held for sale

IFRS 5 outlines a number of 'tests' that assets are required to meet in order to be defined as held for sale. These include the asset being available for immediate sale, actively marketed and the sale highly probable in the next 12 months.

Management, supported by advice from the Council's estates valuer, undertook an assessment of assets previously classified as `non-operational surplus assets held for disposal' under the SORP against the tests in IFRS 5 as at 1 April 2009. Following this review management concluded that £1.770 million of the original £13.894 million balance met the criteria as being `assets held for sale'. The remaining balance has been classified as surplus assets.

We tested a sample of these assets and confirmed that the classification was appropriate. We have requested that management consider the basis of valuation of assets now classified as surplus assets in accordance with the Code. In addition for assets held for sale management should review the classification of these assets between current and non-current.

IAS 7 Statement of cash flows

IAS 7 introduces the concept of cash equivalents that are required to be reported along with cash in the balance sheet and the cash flow statement. This is a new requirement from 2010-11 that did not appear in the SORP. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Within the 2009 restated balance sheet at 2009-10 IFRS balance sheet, the Council has reclassified short term investments as cash and cash equivalents.

We are satisfied that the reclassification made by the Council is appropriate.

IAS 16 Property, plant and equipment

IAS 16 introduces the concept of fair value as a basis for determining the revalued amount of property, plant and equipment. The Code defines fair value as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. For land and buildings this is to be interpreted as the amount that would be paid for the asset in its existing use, which is the same basis that was used in the SORP. If there is no market based evidence because of the specialised nature of the item and the asset is rarely sold, fair value may be estimated using a depreciated replacement cost approach which is a method of valuation which provides the current cost of replacing an asset with its modern equivalent asset.

The Code requires the fair value of council dwellings to be measured using a special existing use value basis for social housing (EUV-SH). Although, the Code does not specify a particular valuation methodology to be used to achieve an EUV-SH valuation, most authorities use a beacon approach (adjusted vacant possession) which seeks to obtain a value for the asset based on its vacant possession market value adjusted to reflect it's use for social housing with a sitting tenant. The Council's valuer revalued the Council dwellings under EUV-SV as at 1 April 2009 which resulted in an increase in valuation of £29.617 million. This upward valuation was due to the difference between the discount factor previously used in the valuation and that now required under IFRS between market and social rents.

We held discussions with the finance staff as well as the Council's valuer in order to understand the basis of valuation, and preparation of the valuation for the 1 April 2009 balance sheet. We are satisfied that the basis of valuation is appropriate and in line with the requirements of the Code.

The Code introduces a number of new classifications of property, plant and equipment and we have reviewed the Council's restatement and are satisfied that these have been appropriately classed. The Code specifically requires land and buildings to be accounted for separately which will include accounting for all revaluation movements. Under the SORP the accounting treatment was not specific and land and buildings could be classed as one single asset, separated for the purposes of depreciation charges. There was no change to the Council financial statements in respect of this, as management had been accounting for land and buildings separately in the previous year's financial statements.

The Code requires that authorities account for separate asset components where these components are significant in relation to the total cost of the asset and where the components have different useful economic lives or depreciation methods. The requirement for componentisation for depreciation purposes is applicable to enhancement and acquisition expenditure incurred, and revaluation carried out, from 1 April 2010. While management have developed their approach to component accounting throughout the period of our appointment as auditors, management should continue to ensure that they have adequate arrangements in place to separately identify and measure separate asset components appropriately.

IAS 17 Leases

Existing leases, both those where the Council is lessor and lessee, were reviewed by management to identify if any require to be re-classified as finance leases in accordance with IAS 17. Management's review focused on consideration of the qualitative factors outlined in the Code as indicators of whether a lease was a finance or operating lease, but had not undertaken any present value calculations in respect of the minimum lease payments.

We reviewed the work performed by management and requested that where one or more indicator had given a potential finance lease conclusion, that a sample of present value calculations were undertaken. On completion of this, management concluded that all the leases entered into, either as lessor or lessee, should remain as operating leases.

We are satisfied that the process undertaken by management is sufficient and in line with the requirements of the Code, and that no adjustments are required to the financial statements in terms of lease accounting.

IAS 19 Employee benefits

An accrual has been incorporated in the opening balance sheet (£6,414 million) and shadow financial statements for untaken annual leave as at the year end (£7.288 million).

In accordance with the Code, management determined the accrual for outstanding leave based on sample testing of untaken annual leave and accrued flexi-time entitlement. Management carried out testing of a proportionate sample of staff from employee groups to identify any required accrual. These findings were extrapolated across each employee group to estimate the required accrual.

We have a agreed a sample of staff to the relevant supporting documentation to confirm their salary and untaken annual leave balances to check the calculation of the holiday pay accruals. Where employees holiday year end is not aligned to the accounting year end the leave accrued to the year end needs to be calculated and compared to the actual holidays taken. This relates primarily to teachers holiday pay.

We are satisfied with the work undertaken by management in relation to employee benefits, however, management should carry out some minor work to ensure that the correct calculation has been performed where staff's holiday entitlement year is not aligned to the financial year and does not accrue proportionately during the year.

IAS 20 Accounting for government grants and disclosure of government assistance

The Code requires that all capital grants shall be recognised immediately, unless there are associated conditions which require to be met. Grants have been accounted for through the statement of comprehensive income and expenditure and any balances on the government grant deferred account have been transferred to the capital adjustment account.

Within the opening 2009 balance sheet £22.950 million was transferred from deferred capital grants account to the capital adjustment account on the balance sheet. Likewise a total of £8.925 million was recognised in the 2009-10 income and expenditure account for capital grant income during the year and £1.900 million of deferred capital grants released to the income and expenditure accounts have been reversed. In accordance with the Code the net adjustment is transferred from the general fund to the capital adjustment account.

We are satisfied with the work undertaken by management in relation to government grants.

IAS 40 – Investment property

The Code interprets IAS 40 by defining investment properties as those held solely to earn rentals or for capital appreciation or both, and not used to deliver services or for administrative purposes. The SORP allowed authorities to classify assets as investment property when they were being held partially for service or policy reasons; this does meet the definition of an investment property under the Code and as such these assets should be reclassified as property, plant and equipment.

The Council undertook a review of investment property held at 1 April 2009 and concluded that the assets did not meet the definition of investment property as the they were being held to support economic development purposes rather than purely capital appreciation or rental income generation. Subsequently the balance of investment property of £49.943 million was transferred from investment property to property, plant and equipment as at 1 April 2009. In line with the requirements of IAS 16: property, plant and equipment these assets were subsequently depreciated within the restated 2009-10 financial statements resulting in an increase in service costs of £427,000.

While we are satisfied that the reclassification of investment property is appropriate, we found that the Council is still identifying a formal estates plan to identify the purpose of each asset held. A number of the assets reclassified relate to property inherited from the previous district council and as such there was no formally documented evidence to support the purpose of the land or building. We are aware that a review of the Council's estate is currently taking place and we recommend that this feeds into the development of an estates plan for each asset. This is not only important for the purposes of classification of assets held but also is a key tool in ensuring efficient and effective use of the Council estate.

Group accounts

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

While we do not expect that the implementation of the Code will impact on the Council's group accounts boundary, we note that at this time we have only been provided with the restated single entity financial statements for the Council.

Review findings (continued)

Other disclosures

The introduction of the Code is expected to lead to considerable changes in the content and presentation of authorities financial statements. One area of change is the adoption of *IFRS 8: Operating Segments*, which requires management to identify appropriate operating segments, and prepare a reconciliation of segmental results to the net cost of services. The Code requires these segments to be consistent with internal management reporting and the disclosure of comparative information. Management has prepared its restated comprehensive income and expenditure account in accordance with requirements of the *Best Value Accounting Code of Practice.* As required by the Code, a note has been prepared disclosing the amounts reported for resource allocation and budget monitoring within the Council's principal directorates, along with a reconciliation to the comprehensive income and expenditure account.

Accounting policies

The accounting policies applied by the Council are determine by the Code. Where the Code does not specifically apply to an item, the Council's management should use judgment in developing and applying an appropriate accounting policy.

As part of the transition to IFRS management have reviewed the Council's accounting policies to ensure that these remain consistent with the Code. We have reviewed the accounting policies and made recommended a number of changes to the draft policies to management to ensure compliance with the Code.

Management should ensure that these accounting polices are considered by the audit and performance review committee at an early stage in the financial statements process.

Conclusion

The figures prepared by management will form the prior year comparators for the 2009-10 financial statements. From the review work undertaken, these figures appear to be appropriate subject to the management actions required.

The following areas require further work to complete the restatement and audit process:

- draft accounting policies have been prepared by the Council, however we recommended that these are approved by the audit and performance review committee;
- management should consider the basis of valuation of assets now classified as surplus assets in accordance with the Code;
- a review should be carried out of assets held for sale to consider the classification of these assets between current and non-current;
- management should carry out further work to ensure that the correct calculation of the holiday pay accrual has been performed where staff's holiday entitlement year is not aligned to the financial year and does not accrue proportionately during the year; and
- the draft IFRS financial statements include a number of disclosure notes which are not required by the Code and additional disclosure notes which have yet to be completed. Management should consider the notes required to be included and the new disclosures required by the Code.