Countdown to IFRS in local government

This is the second in our series of technical briefing papers and looks at the potential issues arising from introducing International Financial Reporting Standards (IFRS) for accounting for non-current assets, formerly referred to as fixed assets.

The paper considers significant aspects of the accounting requirements as set out in the Standards, and it also provides practical examples to help explain potential issues local government bodies may experience when implementing the Standards. The paper considers the following issues:
- potential reclassification implications (IFRS 5 and IAS 40);
- valuation of property, plant and equipment (IAS 16);
- componentisation (IAS 16);
- impairment of assets (IAS 36);
- intangible assets (IAS 38); and
- government and non-government grants (IAS 20).
The CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2010/11 (the Code) has adapted or interpreted the international Standards to meet the specific needs of local government bodies. Where this is the case, the adaptation or interpretation, and its impact, is referred to in the relevant section.

Non-current assets held for sale

IFRS 5: Non-current Assets Held for Sale introduces specific criteria for recognising an asset under this heading. These criteria are difficult to meet and it is likely that authorities may need to reclassify some investment property in their 2010/11 balance sheets. Reclassification may impact on the valuation basis of the assets. Authorities should therefore undertake this work as early as possible to understand the impact on their financial statements and to engage with valuers if necessary.

IFRS 5 sets the following criteria for recognising an asset as held for sale.

- Management is committed to a plan to sell.
- The asset is available for immediate sale.
- An active programme to locate a buyer has started.
- The sale is highly probable, within 12 months of classification as held for sale.
- The asset is being actively marketed for sale at a price reasonable in relation to its fair value.
- Actions required to complete the plan indicate that it is unlikely that the plan will be significantly changed or withdrawn.

These criteria are specific and authorities will need to provide supporting evidence to justify the proposed treatment. It is likely that only a few assets would meet the conditions for classification as held for sale. Assets that are to be abandoned or scrapped would not qualify as assets held for sale as there is no expectation that their carrying amount would be recovered through disposal.

If an asset is recognised as held for sale, it should be reclassified in the balance sheet from non-current assets to current assets. Once classified as held for sale, the asset is no longer depreciated.
Investment properties

IAS 40: Investment Property interprets investment assets as assets held solely to earn rentals, or for capital appreciation, or for both. This is more prescriptive than the Statement of Recommended Practice (SORP). Assets currently classified as investment properties because, in part, they earn rentals, will need reclassifying.

Example 1

A local authority may own small industrial units held under economic regeneration powers. These units may attract rental income, but they are not held solely for that purpose. These assets may need to be reclassified as property, plant and equipment as they are not solely held to earn rental income or for capital appreciation.

Authorities need to review all their properties currently classified as investment properties so assets included under this heading are only those that solely earn a rental income or are held for capital appreciation. CIPFA/LASAAC has provided transitional guidance on the restatement requirements for investment properties.

Valuation of property, plant and equipment

The Code adapts or interprets IAS 16: Property, Plant and Equipment as follows.

- Authorities cannot value infrastructure, community assets and assets under construction at fair value. These assets should be valued at historical cost.
- All other assets will be measured at fair value. For specialist assets where there is no readily identifiable market and the assets are rarely sold, authorities may need to estimate fair value using a depreciated replacement cost approach. The fair value of council houses should be measured using existing use value for social housing (EUV-SH).
- Unless an asset is held to produce cash flows, value in use is the present value of the asset's remaining service potential. This will be at least equal to the cost of replacing that service potential.
- Fair value for land and buildings is the amount that would be paid for the asset in its existing use.

In many respects, the transition to IAS 16 will have little impact on the financial statements as the Standard is not significantly different from the SORP. For instance, the Code states, 'In addition, the valuation method under the Code of existing use value-social housing (EUV-SH) for council dwellings and depreciated replacement cost (DRC) for specialist properties

i  www.cipfa.org.uk/pt/cipfalasaac/transition_guidance.cfm
where there is no market-based evidence of fair value will be the same as under the SORP. However, authorities will need to consider some issues that may result in restatement.

Introducing fair value will, for many asset classes, require little or no change. The transition to IFRS provides an opportunity to review assets classified as specialist assets. Authorities should consider whether there is an open market value for the asset and, if not, apply depreciated replacement cost. The Code criteria for assets classified as surplus or as investment property are also different from the SORP.

The Code requires different accounting where a revaluation loss for an asset has been charged to the Income and Expenditure Account and a later revaluation gain has also been recognised. Under the SORP, the revaluation gain was taken to the Revaluation Reserve. However, under the Code, the gain is initially taken to the Income and Expenditure Account to offset the previous loss. The transition to IFRS requires authorities to account as if IFRS had always applied. Therefore, authorities will need to analyse past revaluation movements in the accounts and restate where necessary.

**Componentisation**

The Code has adapted IAS 16 for componentisation so that the recognition, derecognition and depreciation of significant assets is not applied retrospectively. However, significant components should be recognised for enhancement and acquisition expenditure incurred, and revaluations carried out, from 1 April 2010.

The adaptation in the Code means that authorities will not need to identify and account for significant components as part of the initial IFRS restatement. However, the requirement to recognise components from 1 April 2010 means that authorities need to identify their significant components and consider how they will capture the relevant valuation information.

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.

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i CIPFA/LASAAC Code of Practice on Local Authority Accounting – Para 10.1.2.32.
Example 2

A building is considered to have a useful life of 60 years and a total value of £5 million. The boiler and heating system within the building has a useful life of 25 years and a value of £1 million. Within the terms of IAS 16, the boiler and heating system should be recognised as a separate component. The carrying value of £1 million is depreciated over the 25-year useful life of the component. On replacement, any residual value is derecognised and the cost of the replacement component recognised. Meanwhile, the remainder of the asset, valued at £4 million, is depreciated over the full 60-year useful life of the building.

Recognition of significant components will require the following considerations.

- What significant components exist in each major asset?
  - Discussions with technical departments responsible for maintaining the major asset groups will need to take place. Asset management plans and forward capital programmes will be helpful in identifying replacement programmes that may need to be considered as components. For housing stock, large-scale replacement programmes for kitchens and bathrooms, for example, may need to be recognised as components.

- How will components be recognised in the fixed asset register?
  - Once identified, significant components should be recognised separately in the fixed asset register. Authorities need to have a fixed asset system that will record the separate components of the asset and the separate depreciation charges.

Where assets are scheduled for revaluation during 2010/11, valuers will need to be directed to value those assets, taking account of identified significant components. Where no revaluation is due, but significant components are due for replacement during the year, arrangements will need to be put in place to revalue the significant components within the asset. This will enable replaced components to be derecognised and the new cost to be recognised.
**Impairment of assets**

*IAS 36: Impairment of Assets* has been interpreted by the Code so that where an asset is not held for cash flows, value in use is assumed to equal the cost of replacing the service potential provided by the asset, unless there has been a drop in service potential.

The Code changes the requirements for recognising impairments. The SORP requires impairments arising from the ‘clear consumption of economic benefits’ to be taken directly to the Income and Expenditure Account. However, IAS 36 requires all impairments, regardless of the cause, to be recognised in the Revaluation Reserve up to the credit balance in the reserve for that asset. Any residual balance is then taken to the Income and Expenditure Account.

It is unlikely that adjustments will be required to the opening IFRS-based balance sheet at 1 April 2009 for impairments. The 2009 SORP required an adjustment between the Revaluation Reserve and the Capital Adjustment Account that matches the adjustment that would otherwise be required on transition. However, the 2009/10 accounts may need restating for any impairments classed as ‘consumption of economic benefit’ under the SORP and any associated reversals. CIPFA/LASAAC has provided transitional guidance on this issue, including a spreadsheet giving an example of the required accounting entries.¹

**Intangible assets**

The Code has not adapted or interpreted the requirements of *IAS 38: Intangible Assets*. Therefore, authorities will need to comply with the requirements of the Standard in full.

Any intangible assets that were recognised under the SORP will meet the recognition requirements of the Code and IAS 38. There will not, therefore, be any restatement requirements for those assets. However, the Code recognises a wider range of intangible assets than the SORP. Authorities need to consider whether they hold intangible assets within the scope of the Code which are not currently recognised in their SORP-based accounts.

The SORP only allowed internally developed intangible assets, such as software, to be capitalised where there was a readily ascertainable market value. This restriction does not exist under the Code. It is possible that expenditure charged to the Income and Expenditure Account under the SORP will need to be restated and recognised as an intangible asset.

Some authorities may have developed software internally as part of a larger IT procurement scheme funded as capital. The software costs may have been charged to the Income and Expenditure Account as Revenue Expenditure Funded from Capital under Statute. If the authority restates the asset as an intangible asset under the Code, the expenditure will need reversing out of the Income and Expenditure Account.

**Government and non-government grants**


- The scope of the Standard is extended to include grants and contributions from non-government bodies.
- Grants and contributions for capital purposes are recognised immediately unless any conditions have not been met. Authorities should not include grants and contributions deferred in the Balance Sheet.
- The transfer of donated assets for nil consideration or less than fair value should be credited to a Donated Assets Account where any conditions of the transfer have not been met.
- Deducting the grant from the carrying amount of the asset is not permitted.

The changes in the Code and IAS 20 represent a change of accounting policy. Authorities will, therefore, need to review their accounting treatment for government and non-government grants and donated assets and assess whether that treatment is consistent with the requirements of the Code. In particular, authorities will need to assess whether any conditions applied to the grant or contribution are outstanding in considering if it should be recognised as income.

**More information**

Please visit [www.audit-commission.gov.uk/IFRS](http://www.audit-commission.gov.uk/IFRS) for more information about IFRS and to find further briefings on implementing IFRS in local government.
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