Practical implications of restating non-current assets

Countdown to IFRS in local government

This International Financial Reporting Standards (IFRS) briefing paper focuses on the practical issues authorities may face when restating non-current assets. It does so by considering practical ways of addressing the following questions:

- How do you identify what assets you are using?
- How do you decide whether you need to account for an asset?
- How do you account for significant components of assets?
In our previous technical briefing papers, we have looked at the accounting requirements for non-current assets, formerly known as fixed assets, considering the implications for property, plant and equipment, leases, and service concessions.

The accounting requirements for many of these transactions and balances are well documented. The Chartered Institute of Public Finance and Accountancy and the Local Authority (Scotland) Accounts Advisory Committee (CIPFA/LASAAC) have now published transitional guidance notes to support the 2010 Accounting Code and accounting for service concessions is incorporated into the 2009 Statement of Recommended Practice. However, for many authorities, the practical issues involved in identifying and locating documentation relating to, in some cases, large numbers of non-current assets and then considering how to account for those assets poses a significant challenge.

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i Code of Practice on Local Authority Accounting in the United Kingdom 2009: A Statement of Recommended Practice, published July 2009 CIPFA/LASAAC.
What assets are you using?

The starting point for assessing what assets may need to be recognised on the balance sheet must be to identify what assets you are using in your day-to-day business. For many assets this will be straightforward. Existing asset registers should identify those assets that are already recognised on the balance sheet, including any assets held under finance leases. But, as we discussed in our first technical briefing on leases, differences between the international standard on leasing, IAS 17, and SSAP 21 may result in operating leases needing to be reclassified as finance leases. Therefore, all leases will need to be identified so a review can be undertaken to assess the appropriate accounting treatment. We consider how this can be done effectively later in the paper.

The requirements of IFRS extend beyond purchased assets and leases. As we discussed in our previous briefing paper Identifying and Accounting for Leases, IFRIC 12 Service Concession Arrangements and IFRIC 4 Determining Whether an Arrangement Contains a Lease mean that you need to consider any other asset that is being used by the authority against the relevant criteria.

Under IFRIC 12, the relevant criteria are:
- the authority controls the services provided in relation to the asset, to whom and at what price; and
- the authority controls the residual interest in the asset at the end of the contract.

This will cover private finance initiative (PFI) schemes, but may go wider. We will look in more detail at other arrangements that may be covered later in this paper.

Under IFRIC 4, the relevant criteria are:
- the arrangement requires the use of a specific asset or assets; and
- the arrangement contains all but an insignificant amount of that asset or assets.

It is, therefore, important to understand what other arrangements the authority has that involve the use of assets of buildings, land, vehicles or machinery. It is also important to remember that the arrangement does not need to be a formal, binding contract. Partnerships or even custom and practice sharing arrangements may need to be considered.

Most local authorities are complex organisations and larger authorities may need to consider a wide range of arrangements that use assets. Therefore, the task of reviewing arrangements cannot be done by the finance department alone. Operational managers need to help to identify and review arrangements, and this may most effectively be done by creating a working group comprising key operational managers from all service departments.
This cross-organisational working group will need to coordinate an authority-wide review to identify all assets used and the nature of the arrangement through which they are used. It is not possible to provide an exhaustive list of what arrangements may exist, as this will depend on local circumstances. However, Table 1 shows examples of arrangements that have been identified to date.

Table 1

<table>
<thead>
<tr>
<th>Nature of asset</th>
<th>Considered under:</th>
</tr>
</thead>
<tbody>
<tr>
<td>PFI/PPP/LIFT assets</td>
<td>IFRIC 12</td>
</tr>
<tr>
<td>Leased assets (e.g. buildings, vehicles, IT equipment, photocopiers)</td>
<td>IAS 17</td>
</tr>
<tr>
<td>Accommodation used under joint arrangements (e.g. offices, leisure centres attached to schools).</td>
<td>IFRIC 12 or IFRIC 4</td>
</tr>
<tr>
<td>Externally operated residential homes.</td>
<td>IFRIC 12 or IFRIC 4</td>
</tr>
<tr>
<td>Assets used under licences to operate (e.g. outsourced refuse collection arrangements).</td>
<td>IFRIC 4</td>
</tr>
<tr>
<td>Schools not in the ownership of the local education authority (e.g. academies, voluntary aided schools).</td>
<td>IFRIC 12 (we are discussing the accounting treatment of such schools with CIPFA)</td>
</tr>
</tbody>
</table>

Source: Audit Commission

Once a comprehensive schedule of assets has been identified, further work is then required to consider the correct accounting treatment.
How do you decide whether you need to account for an asset?

**Assets considered under IFRIC 12 and IFRIC 4**

As we identified in our IFRS briefing *Identifying and Accounting for Leases*, assessing whether an asset falls within the scope of IFRIC 12 or IFRIC 4 requires compliance with the criteria in each standard. The following decision tree (Figure 1), which was included in the leasing briefing, will help in those considerations.

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**Figure 1: Decision tree: Lease arrangements identification process**

**IFRIC 12**

- Does the arrangement involve a public to private transfer? 
  - Y
  - Does the public sector have control of the services provided? 
    - Y
    - Recognise PPE asset as if finance lease under IAS 17
    - N
    - Does the public sector have control of residual interest in the asset? 
      - Y
      - N
      - N
      - N
  - N

**IFRIC 4**

- Does the arrangement rely on the use of a specific asset or assets? 
  - Y
  - Does the arrangement convey the right to use all but an insignificant amount of the asset? 
    - Y
    - Recognise expenditure as payment for services as it falls due
    - N
    - N
  - N

Source: Audit Commission
Because individual arrangements will vary, the final accounting treatment may be different for apparently similar arrangements. Table 2 presents indicators that may be helpful when considering whether an arrangement falls within the scope of IFRIC 12 or IFRIC 4.

Table 2

<table>
<thead>
<tr>
<th><strong>IFRIC 12</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Does the arrangement involve a public to private transfer?</strong></td>
<td>Any arrangement with another local authority, NHS body or government department would not be deemed to be a public to private transfer. Because of the government’s definition of the public sector ‘boundary’, housing associations and charitable bodies are deemed to be private sector.</td>
</tr>
</tbody>
</table>
| **Does the public sector have control of the services provided?** | Services provided must be more than the routine landlord services that would be expected in a lease arrangement, such as maintenance. The following would indicate control over services provided:  
  - Restriction of the use of an asset to only employees of the authority.  
  - Control of nomination rights.  
  - Control over the level of rents or charges that can be levied. |
| **Does the public sector have control of residual interest in the asset?** | The following would indicate control of residual interest:  
  - Automatic reversion of the asset to the authority at the end of the arrangement.  
  - Evidence that the full useful economic life of the asset is consumed during the life of the arrangement.  
  - An option to purchase the asset at the end of the arrangement at a discounted value.  
  - A legal charge over the asset that restricts its disposal. |

<table>
<thead>
<tr>
<th><strong>IFRIC 4</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Does the arrangement rely on the use of a specific asset or assets?</strong></td>
<td>This test would be met where the contract identified a specific asset or assets to be used, such as a fleet of refuse vehicles or a named building.</td>
</tr>
<tr>
<td><strong>Does the arrangement convey the right to use all but an insignificant amount of the asset?</strong></td>
<td>A fleet of refuse vehicles painted in the authority’s livery and only used for refuse collection in the authority’s area would meet the requirements of this test. Use of vehicles by external maintenance staff who also undertake work on other contracts would not meet the requirements of this test.</td>
</tr>
</tbody>
</table>

*Source: Audit Commission*
**Assets used in a joint arrangement**

Authorities may be involved in joint arrangements where the use of assets is shared with another local authority or public sector body. For example, two or more local authorities may both use a refuse disposal centre procured under a PFI deal. In such circumstances, all of the tests under IFRIC 12 may be met, in as much as the public sector as a whole is controlling the services to be provided and the residual interest in the asset. However, consideration then needs to be given to how the asset is recognised by the public sector in total. The following examples look at the most common form of arrangements.

**Example A**

Authorities A and B are joint signatories to a PFI scheme with a private sector operator for the provision of a refuse disposal site with a total value of £10 million. Under the agreement, authority A uses 60 per cent of the facility and authority B uses 40 per cent. All proposals for access to the site, opening hours, etc., must be approved by both authorities. The residual value of the asset at the end of the 25-year contract is £3 million and, at the end of the contract, the asset will revert to authority A.

In this case, there is joint control over the use of the asset and, through the reversion of ownership to authority A at the end of the contract, control of residual interest. In this case, it would be reasonable for both authorities to recognise their share in the asset. Authority A would initially recognise an asset of £6 million and authority B an asset of £4 million. As authority A will own the asset at the end of the arrangement, it will depreciate its share of the asset down to the residual value of £3 million over the life of the arrangement. However, authority B has no residual interest so will depreciate its share down to zero.
**Example B**

Authority A is signatory to a PFI scheme with a private sector operator for the provision of a refuse disposal site with a total value of £10 million. All proposals for access to the site, opening hours, etc., must be approved by authority A. The residual value of the asset at the end of the 25-year contract is £3 million, and at the end of the contract, the asset will revert to authority A. Under a separate arrangement, authority A provides access to the facility to authority B, who uses approximately 40 per cent of the facility’s capacity.

In this case, the arrangement between authority A and the private sector operator constitutes the service concession. Therefore, authority A would initially recognise the whole asset of £10 million. However, consideration then needs to be given to the sub-arrangement with authority B. As this element represents a public to public transfer, consideration would be under IFRIC 4 rather than IFRIC 12.

**Leases**

Whether you are considering arrangements that take the legal form of a lease or have identified arrangements under IFRIC 4 that need to be considered as leases, these need to be considered under IAS 17 Leases. This can be a daunting prospect where large numbers of arrangements have been identified. We are already aware that some larger metropolitan authorities have identified in excess of 10,000 leases that need to be reviewed.

Logistically, the review of that number of arrangements on a case-by-case basis will be beyond the available resources of most authorities. An approach therefore needs to be adopted that will address the most significant risks to the misstatement of the financial statements. Figure 2 suggests an approach that could be taken to manage such an exercise.

The risk axis considers the likelihood of not being able to restate in time for the 2010/11 accounts. The impact axis considers how great the effect on the financial statement would be if the analysis was wrong.

The aim is to move away from the top right hand corner by:
- moving down (e.g. getting evidence to demonstrate that an issue is not material); and
- moving left (e.g. putting in resources/systems, etc. to restate the item).
Figure 2

<table>
<thead>
<tr>
<th>Impact</th>
<th>Monitor</th>
<th>Reduce risk</th>
<th>Major risk</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Monitor</td>
<td>Reduce risk</td>
<td>Reduce risk</td>
</tr>
<tr>
<td>Minimal impact</td>
<td>Collect evidence</td>
<td>Collect evidence</td>
<td></td>
</tr>
</tbody>
</table>

Source: Audit Commission

Figure 3 shows that for leases, the risk of not being able to restate is high and the potential impact on the accounts is high.

Figure 3

<table>
<thead>
<tr>
<th>Impact</th>
<th>Thousands of leases to be reviewed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Audit Commission

However, it should be possible to break leases down into a number of more easily manageable classes.

In Figure 4, 250 leases have been identified that, considered individually, would be material to the accounts. Each of these will need to be considered individually and the appropriate accounting treatment assessed.

It should also be possible to analyse other leases into classes. Many authorities use standard forms of leases for items such as photocopiers and vehicles. By grouping these leases into classes, the appropriate accounting treatment can be assessed by considering a sample of leases, rather than looking at each individual arrangement.

By identifying the value of all leases in a class, it will also be possible to assess whether, as a whole, that class of leases is material to the accounts. Greater emphasis should be placed on reviewing those classes deemed to be material.
Figure 4

<table>
<thead>
<tr>
<th>Impact</th>
<th>250 material leases</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Class of leases that may be material</td>
</tr>
<tr>
<td></td>
<td>Classes of leases unlikely to be material</td>
</tr>
</tbody>
</table>

Source: Audit Commission

Ultimately, such an approach should lead to a situation where all material leases and classes of leases are reviewed and restated, reducing the level of risk. While a risk remains that non-material leases may be incorrectly classified, the impact on the accounts has been reduced because of their non-material nature.

Figure 5

<table>
<thead>
<tr>
<th>Impact</th>
<th>All material leases restated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Other leases assessed as not material</td>
</tr>
</tbody>
</table>

Source: Audit Commission

In adopting such an approach, you will need to document your approach, the judgements taken and the results of reviews, including where these have been done on a sample basis. It is this evidence that auditors will seek to rely on when they undertake their audit work on the restatement. While there are ethical constraints on what auditors can do to help you, an early discussion with your auditor will help to clarify whether your proposed approach will provide the assurance they will be looking for. In an earlier IFRS briefing paper, *The Move to International Financial Reporting Standards – How Can Your Auditor Help?*, we considered those ethical constraints in more detail.

**How do you identify significant components of assets?**

In our previous IFRS briefing *Accounting for Non-current Assets*, we noted that, from 1 April 2010, authorities need to recognise enhancement and acquisition expenditure, and valuations, for those components of an asset that have a significant value in their own right and that have a significantly different asset life to the overall asset.
That analysis is not something that can be done in isolation in the finance department. Discussions should be undertaken with the technical departments responsible for the maintenance of the authority’s material assets, such as administrative buildings, housing stock, schools and leisure centres and swimming pools, to identify programmed major capital works involving the replacement of material components.

It will be for individual authorities to identify what they consider to be material components. However, from experience to date, such components may include:

- **Administrative buildings and schools:**
  - boiler and heating systems;
  - lifts;
  - electrical rewiring; and
  - flat roofs.
- **Housing stock:**
  - replacement kitchens and bathrooms; and
  - boiler and heating systems in tower blocks.
- **Leisure centres and swimming pools:**
  - boiler and filtration systems.

Having identified material components, you will need to ensure that:

- asset registers are amended and updated to record those components, including their value, useful economic life and remaining useful life; and
- valuers are instructed to provide values for relevant assets that recognise the identified components within them.

**What do auditors need to know?**

The issues discussed in this paper require a significant degree of judgement and use of estimations. As such, it is for individual authorities to establish which accounting policies and estimation techniques they intend to use and demonstrate how the approach to restatement has met these. When undertaking their audit work on the restatement, auditors will wish to see what accounting policies the authority has adopted and whether the estimation techniques and review processes employed will enable financial reporting in accordance with those accounting policies.

It is, therefore, important that, in undertaking the restatement work described above, you document fully the approach you have taken, what estimation techniques have been used where appropriate and what the outcomes of those reviews have been.

**More information**

Please visit 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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