# Audit and Standards Committee

# 5 November 2020

# Warwickshire County Council – Changes to Accounting Policies

## Recommendations

The Audit and Standards Committee is recommended to:

(a) Agree that the accounting policy for group accounts outlined in paragraph 2.7 should be used as the basis for the preparation of the 2020/21 Warwickshire County Council Statement of Accounts, or any subsequent year thereafter should the criteria for the production of group accounts be met;

(b) Agree that the accounting policy for leases outlined in paragraph 3.13 should be used as the basis of the preparation of the 2021/22 Warwickshire County Council Statement of Accounts and the additional disclosure notes required in 2020/21;

(c) Note the amendments to the presentation of the statement of accounts in paragraphs 2.8 and 3.17 that will result from the changes in accounting policy.

### 1. Purpose of the Report

1.1. As a local authority we are required to comply with the CIPFA Code of Practice on Local Authority Accounting (the Code) when preparing our annual accounts. The Code requires that we produce group accounts if we are involved with companies that meets the threshold of materiality. As an authority we are likely to reach this position either in 2020/21 or 2021/22. The Code also includes additional disclosure requirements in relation to leases that will take full effect for the 2021/22 accounts.

1.2. As part of their remit, in recommending the annual Statement of Accounts to Council for approval, the Audit and Standards Committee are required to approve accounting policies on which the financial statements are based, and the approach adopted by the Authority in complying with accounting requirements. It is therefore best practice where there has been a potentially

material change in accounting policy the Audit and Standards Committee are able to consider and approve this change before it is implemented as part of the year end accounts production process (CIPFA's publication "Audit Committee: Practical Guidance for Local Authorities" (2018)).

1.3. Also under Auditing Standards (ISA 260) the external auditors will report to the Audit and Standards Committee their views on the acceptability of our accounting policies and, as there has been a change, they will comment on it in their formal Audit Findings Report that will come to the Committee in July 2021. This reinforces why it is recommended practice that the Audit and Standards Committee should be aware of and approve any changes to accounting policies prior to the external auditors commenting on them.

1.4. Consequently, this report outlines our proposed approach to meeting the accounting requirements for group accounts and the new requirements for reporting leases and seeks the agreement of the Audit and Standards Committee to the accounting policies we will use as the basis for the preparation of the Warwickshire County Council Statement of Accounts for 2020/21 and future years.

1.5. The Committee should note that we have fully engaged with the external auditors as the approach outlined in the report was developed and also in how we intend to provide assurance about this impact of the change on our financial statements. The external auditors have indicated they are content with the approach outlined in the report.

## 2. Group Accounts

Overview of Group Accounts

2.1. The County Council has approved the creation of a wholly owned Warwickshire Property and Development Company (WPDC) as the preferred delivery option for its land and property assets to assist the Council in meeting its strategic drivers for place shaping. Unlike Educaterers Ltd and Warwickshire Legal Services Trading Ltd, it is expected that WPDC will cross the materiality threshold and therefore the County Council will be required to produce group accounts alongside the County Council's standalone statement of accounts.

2.2. WPDC will be a wholly owned entity through a mix of debt and equity. The exact mix has not yet been finalised. Financial statements will be impacted as and when assets and loans are transferred to WPDC that are in excess of our

materiality threshold (approximately £13m in 2019/20). The purpose of bringing forward this report now is to ensure we are prepared to produce group accounts as and when required.

Basis of consolidation

2.3. The County Council has strict statutory deadlines for the completion and auditing of our accounts. These timescales will, going forward, also apply to the production and auditing of any group accounts we are required to produce.

2.4. The Code and International Financial Reporting Standards (IFRS) require that the financial statements of the reporting authority (Warwickshire County Council) and its subsidiaries, associates and jointly controlled entities shall be prepared as of the same date. However, the year-end date and reporting timescales of WPDC and any other entities we are required to consolidate may not be 31 March. Where this does not happen, for consolidation purposes, additional financial statements, as of the same date as the County Council will be prepared unless it is impracticable to do so. Therefore, for consolidation purposes we will either use draft accounts as of 31 March or a combination of part year audited accounts and management accounts for the balance of the financial year.

2.5. WPDC and other subsidiaries will be consolidated into the group accounts on a line-by-line basis incorporating their income and expenditure fully in the relevant service revenue accounts. Joint ventures will be consolidated into the group accounts under the equity method i.e. we will only consolidate our proportionate share of any joint venture company.

2.6. Whilst our other wholly owned companies are not material to our Statement of Accounts we will not consolidate their accounts into the County Council's Group Accounts but will continue to report them under the Related Parties note.

Group Accounts Policy

2.7. The proposed accounting policy in relation to Group accounts is as follows:

> *The Council has interests in companies and other entities. Where these interests are material and satisfy one of the criteria tests: that the Council has control, either individually or jointly with another party; or has significant influence over the entity, then group accounts will be prepared in accordance with the IFRS based CIPFA Code of Practice on Local Authority Accounting. In the Council's own*

*single entity accounts, the interests in companies and other entities are classified as Long-Term Investments and valued at fair value.*

Impact on the Financial Statements

2.8. As part of approving a new accounting policy the Committee needs to take into account the impact on the financial statements. The need to produce group accounts will not impact on the financial statements of the County Council itself. Instead it will require a number of additional statements to be produced and considered alongside the traditional accounts. Collectively these are expected to increase the length of the overall accounts by 10-20 pages.

2.9. The additional financial statements we will be required to produce are:

- An overview of the group accounts;
- Group comprehensive income and expenditure statement;
- Group movement in reserves statement;
- Group balance sheet;
- Group cash flow statement;
- A reconciliation between the County Council's accounts and the group accounts;
- Group tax expenses;
- Group companies' disclosure; and
- A series of notes to the group balance sheet.

2.10. The Committee are asked to approve the accounting policy for group accounts as set out in paragraph 2.7.

## 3. Leases

Overview of Leases

3.1. In addition to purchasing any assets outright, there are two types of leases that organisations can enter into to obtain access to the assets they need to undertake their operations. These are called finance leases and operating leases and the accounting treatment for each is different. Finance leases are effectively accounted for as acquisitions (with the asset on the balance sheet, together with a liability to pay for the asset acquired). In contrast, operating leases are treated as 'pay as you go' arrangements, with rental payments charged to the revenue account over the term of the lease.

3.2. The 2008 financial crisis raised concerns about transparency of information which was off-balance sheet. A particular concern was that for a lot of organisations there was no balance sheet recognition of leased assets or any consequent liabilities for lessees (the body using the asset) where they were classified as ‘operating leases’.

3.3. In response to this, IFRS 16 ‘Leases’ was issued by the International Accounting Standards Board (IASB) in 2016. Its main impact is to remove (for lessees) the traditional distinction between finance leases and operating leases. IFRS 16 requires all substantial leases to be accounted for using the acquisition approach, recognising the rights acquired to use an asset. This effectively means that for all substantial leases the lessee has to account for them as an acquisition.

3.4. IFRS16 was initially intended to be adopted for local government in the 2020/21 financial year. However, due to COVID-19, implementation has been deferred to the 2021/22 financial year, with an effective date of 1 April 2021.

Key Issues

3.5. IFRS 16 requires all lessee leases (with two exemptions noted in paragraph 3.9) to be accounted for as finance leases, recognising the rights to use an asset i.e. accounted for as though the Authority had purchased the asset. These changes to IFRS16 do not apply where WCC is acting as the lessor.

3.6. To account for a leased asset as though we had purchased it requires us to determine three things to support the initial recognition of the asset:

- The value of the asset being leased;
- How much to charge to the income and expenditure account each year for the amount of the assets value used; and
- How the asset will be financed.

3.7. From 2021/22, the amount of annual lease payments will be split between an interest element and the principal element. Our proposed approach to determining the initial value of the asset will be to use the ‘cost model’ which in effect equates the value of the leased asset as the sum of the principal repayments within the lease contract. This approach works for all assets except where assets are leased for a concessionary or nil consideration. Where leases are provided at a concessionary rate (e.g. peppercorn) or nil consideration this approach would result in an understatement of the value of the asset. Consequently, assets from such arrangements will need to be recognised at Fair Value, but with no associated liability. In essence they will

be treated as donated assets. These valuations will be undertaken as part of the Council's independent asset valuation contract.

3.8. After the initial recognition of leased assets on the Council's balance sheet the assets will be revalued and accounted for in accordance with the Council's current valuation policies for property, plant and equipment assets.

3.9. There are two exemptions for lessees from applying this standard. These are:
1) Short term leases and;
2) Leases where the value of the asset that the lease relates to is low.

3.10. The definitions we propose to apply when using these exemptions are:
1) Short term leases will be defined as those with a lease term of twelve months or less at the date of their initial recognition and;
2) Leases where the value of the asset that the lease relates to is low will be defined as those where the value of the asset is less than £6,000. The Code and IFRS16 allows organisations to determine a monetary amount that would constitute low value and the proposed level of £6,000 is the Council's approved de-minimis level for capital expenditure.

Exempt leases will continue to be accounted for as operating leases.

3.11. As part of our current accounting policies we make an annual charge to revenue for the use of assets through our depreciation policy. Our depreciation policy is that assets are depreciated on a straight-line basis over their useful life, with a full year's depreciation beginning the year after their initial recognition on the balance sheet. These proposals do not change this policy other than the requirement within IFRS16 to depreciate leased assets on a straight-line basis using the lower of the remaining useful life of the asset or the remaining years on the lease liability.

3.12. The introduction of increased numbers of finance leases onto the balance sheet will increase the level of capital spend to be financed i.e. the Capital Financing Requirement. Without any other change this would increase the Minimum Revenue Provision (MRP) set aside as part of annual budget setting to repay debt. However, the Council is already making lease rental payments for these assets and therefore an adjustment will be made to avoid budgets having to be set aside to fund the assets twice. The adjustment will be equal to the principal element of the lease payment so providing for a "net nil" effect on the revenue budget.

Leasing Policy for 2021/22

3.13. The proposed accounting policy in respect of leases that will be in place for the 2021/22 accounts is as follows:

*Leases are a contract, or part of a contract, that conveys a right to use an asset for a period of time in exchange for consideration. The right to use the asset and the associated liability are recognised in the balance sheet and accounted for as finance leases.*

*Measurement*
*For the majority of leased assets we will use the 'cost model' to determine the initial value, which equates the value of the leased asset to the sum of the principal repayments within the lease contract. The exception is where leases are provided at a concessionary rate. Assets from such arrangements will be recognised at Fair Value, but with no associated liability. Our valuation process is led by the Council's Property Management Team, who commission external valuers as needed.*

*After the initial recognition of leased assets on the Council's balance sheet the assets will be revalued and accounted for in accordance with the approach set out in our accounting policy for Property, Plant and Equipment.*

*Finance leases*
*We deal with finance leases where we are the lessee in the same way as other capital spending. We include these as assets in the Balance Sheet and charge depreciation on them. Rentals are apportioned between a charge for the acquisition of the asset (recognised as a liability in the Balance Sheet at the start of the lease and written down annually as rent becomes payable) and a finance charge made each year to the CIES. There are two exceptions to the treatment of operating rather than finance leases, these are:*
*1) Short term leases will be defined as those with a lease term of twelve months or less at the date of their initial recognition and;*
*2) Leases where the value of the asset is less than £6,000.*

*Operating leases*
*Lease rental payments (as lessee) are charged evenly to the CIES over the life of the lease.*
*Where we grant an operating lease (as lessor) over a property or item of plant or equipment, the asset is retained on the Balance Sheet and the rental income is credited to the CIES as it is due.*

*We do not disclose contingent rents as they are not material to the financial statements.*

Lease Activity

3.14. Our records show that we have 163 leases, licences and other arrangements that we have entered into in relation to property/estates. A minimum 35 properties that will be classified as right-of-use assets plus 17 larger vehicles and pieces of equipment which we will be bringing on to the Asset Register and including in the Property, Plant and Equipment line in the Balance Sheet. Work is still on-going to quantify the effect of this change. We are reviewing the contracts for the remaining 128 property/estates arrangements to identify the value of the asset and whether it fits into either of the exemption categories. Work is also on-going to identify all leased assets held by schools.

Impact on the Financial Statements in 2020/21

3.15. The 2020/21 Financial Statements will not be prepared on an IFRS16 basis. The only impact will be the requirement to state that the standard has been issued but not yet adopted, similar to the wording contained in the 2019/20 Statement of Accounts. We will, however, disclose the estimated financial impact of moving to an IFRS16 compliant basis for reporting.

3.16. The implementation of this standard will not require the authority to restate the 2020/21 accounts on an IFRS16 compliant basis. Instead we will make opening balance adjustments on 1 April 2021 for the 2021/22 accounts. It is therefore important that the accounting policy is agreed at the earliest opportunity to allow the estimated financial impact to be assessed and the data collated on an on-going basis rather than trying to undertake the work retrospectively.

Impact on the Financial Statement in 2021/22

3.17. The application of IFRS16 will have an impact on various parts of the 2021/22 Financial Statements in terms of both the presentation of the accounts and additional disclosure notes. As well as the opening balance adjustments the elements we will need to disclose are:

- Right-of-use assets as a separate line on the balance sheet or as a sub-set of the Property Plant and Equipment line with a reconciling disclosure note;
- Lease liabilities as a separate line on the balance sheet or within other liabilities with a reconciling disclosure note;

- Depreciation of right of use assets within the relevant service expenditure line in the net cost of services;
- Interest payable on right-of-use assets;
- MRP on right-of-use assets;
- The cost of short-term leases and low value leases;
- Total cash outflow for leases;
- Carrying amount of right-of-use assets by class of asset;
- Financial liability and maturity disclosures;
- The nature of leasing activities; and
- Leases signed but not yet commenced.

## 4. Financial Implications

4.1. There will be no direct financial impact for the Council as a result of the introduction of the new accounting standard for leasing or flowing from the introduction of group accounts.

4.2. There will be an additional resource commitment for the Finance Service in producing the group accounts and in particular in undertaking the due diligence on any use of unaudited company management accounting information as part of the consolidation process. The level of this is currently being quantified and will form an initial commitment for the use of any income generated as a result of the investment.

4.3. There will also be an additional resource commitment initially to create and then maintain a Council leasing register. This is currently being managed from within existing resources, but a request for additional funding to the Council Change Fund will be made if further capacity is required.

4.4. IFRS16 will increase the number of assets on our balance sheet required to be valued at Fair Value on an annual basis in future years, this increase may impact on the contract cost to procure independent valuations of our assets. It is not possible to assess the scale of the cost at this stage as the contract will be retendered before the new standard is applied.

## 5. Environmental Implications

5.1. None.

## 6. Background Papers

6.1. None.

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No elected members have been consulted in the preparation of this report.