The Chartered Institute of Public Finance & Accountancy

LAAP BULLETIN 102

Accounting for Collaboration-Transition Issues

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The Local Authority Accounting Panel issues LAAP Bulletins to assist practitioners with the application of the requirements of the Code of Practice on Local Authority Accounting, SeRCOP and Prudential Code, and to provide advice on emerging or urgent accounting issues. Bulletins provide influential guidance that is intended to be best practice, but are not prescriptive and do not have the formal status of the Code, SeRCOP or Prudential Code.

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Introduction

1. Chapter 9 Group Accounts of the Code of Practice on Local Authority Accounting in the UK 2014/15 (the Code) contains revised provisions following the issue of new IFRS standards and the amendment of related existing standards. The new provisions have effect in three main areas:

    - a new definition of subsidiaries based on a remodelled control test (IFRS 10 Consolidated Financial Statements)
    - new classifications for joint operations and joint ventures (IFRS 11 Joint Arrangements)
    - extended and revised disclosure requirements for group accounts (IFRS 12 Disclosure of Interests in Other Entities)

2. Guidance on these changes is generally available in the CIPFA publication *Accounting for Collaboration*. This Bulletin deals with issues specifically relating to making the transition from the old to the new arrangements.

3. The changes have the potential to shift collaborative arrangements across an authority's group boundary, bringing new arrangements within the scope of group accounts or removing ones previously included. As the result of a change in accounting policy, such shifts would normally be accounted for as prior period adjustments, with full retrospective restatement of transactions and balances as if the new policy had always applied.

4. The Code recognises that this may be problematic. For instance, if the remodelled control test were to newly classify as a subsidiary an entity which the authority effectively took control of in 1994, restatement would require a business combination to be accounted for as it happened 20 years ago. The Code therefore contains a number of concessions that recognise practicable limits to making prior period adjustments.

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Impracticability

5. The concessions are based on requiring things to be done except to the extent that they are impracticable. Impracticability is defined in paragraph 3.3.2.3 of the Code as the inability to apply a requirement after making every reasonable effort to do so. Changes in accounting policy or corrections of errors are not applied for a particular year where:

    - the effects of the retrospective application or retrospective restatement are not determinable
    - the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period, or
    - the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively, from other information, information about those estimates that:

- provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed, and
- would have been available when the financial statements for that prior period were authorised for issue.

Basic Requirements

6. Unless the Code (or IFRS) provides an exemption, any changes in accounting policy relating to group accounts will need to be accounted for in accordance with section 3.3 of the Code, ie, by retrospective application. For changes dating back before 2013/14, this entails adjusting the balance of each affected component of net worth at 1 April 2013 and the other comparative amounts disclosed for 2013/14 as if the new accounting policy had always been applied (paragraph 3.3.2.13).

7. Appendix C of the 2014/15 Code sets out the following specific requirements for disclosures in relation to the new or amended group accounts standards:

   - a restated Balance Sheet at 1 April 2013 (Third Balance Sheet) where changes are material
   - a narrative description that the change in accounting policy is as a result of the Code's adoption of the amendments to the group accounts standards
   - the nature of the change of the accounting policy
   - for 2014/15 and 2013/14, the amount of the adjustment to each line item in the financial statements affected, to the extent practicable
   - the amount of the adjustments relating to the prior period before 1 April 2013, to the extent practicable

8. These basic requirements are then modified by provisions in paragraphs 9.1.2.64 to 9.1.2.72 of the Code. The modifications cover eight main areas:

   - when to apply the new IFRS 10 control test for subsidiaries
   - what to do if an entity is a subsidiary under both the old (IAS 27 Consolidated and Separate Financial Statements/SIC-12 Consolidation – Special Purpose Entities) and the new control tests
   - setting a deemed date for the acquisition of control of newly defined subsidiaries
   - which standards to apply when accounting for the business combination of a new subsidiary
   - no longer consolidating a subsidiary
   - switching from consolidation to equity accounting for joint ventures
   - switching from equity accounting to asset/liability accounting for joint operations
   - disclosure notes

Applying the new IFRS 10 control test for subsidiaries

9. Paragraph C2B of IFRS 10 Consolidated Financial Statements confirms that the new control test is to be applied from the beginning of the reporting period for which IFRS 10 is applied for the first time. This means 1 April 2014 for the purposes of the Code. Consequently, entities that would have been subsidiaries under the IFRS 10 test but where control was lost before 1 April 2014 are outside the scope of the new arrangements.

10. No account therefore needs to be taken of entities that would only have been subsidiaries under the new test but ceased to be controlled by an authority in 2013/14 (eg, because the authority disposed of or reduced its interest).

No change in subsidiary status

11. Paragraph 9.1.2.65 of the Code confirms that adjustments are not required to amend the previous group accounts treatments (inclusion or exclusion) for entities where the consolidation conclusion is the same under the old and the new definitions of subsidiaries.

12. This might have been significant if the IAS 27/SIC-12 tests had defined a different date for when control of a subsidiary was secured, but paragraph 9.1.2.65 removes all possible complications.

Deemed date for the acquisition of control of subsidiaries

13. Paragraph 9.1.2.66 of the Code sets out the steps to be taken for an entity that is to be consolidated that was not previously treated as a subsidiary.

14. The relevant treatment depends on whether the entity is a business (per IFRS 3 *Business Combinations*) or just a collection of assets. The IFRS 3 definition of a business is "… an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants".

15. If the entity is a business, the steps are:

- measure the assets, liabilities and minority interests[1] in the entity on 1 April 2014 as if the subsidiary had been consolidated (and thus had applied acquisition accounting in accordance with IFRS 3) from the date when the authority obtained control per the Code's requirements for IFRS 10
- adjust retrospectively 2013/14 comparative figures
- if the date that control was obtained is earlier than 1 April 2013, recognise, as an adjustment to reserves at 1 April 2013, any difference between:
    - the amount of assets, liabilities and minority interests recognised, and
    - the previous carrying amount of the authority's involvement with the subsidiary.

16. If the entity is not a business, the steps are:

- measure the assets, liabilities and minority interests in the entity as if the subsidiary had been consolidated (applying the acquisition method as described in IFRS 3 but without recognising any goodwill for the investee) from the date when the authority obtained control per the Code's requirements for IFRS 10
- adjust retrospectively 2013/14 comparative figures
- if the date that control was obtained is earlier than 1 April 2013, recognise, as an adjustment to reserves at 1 April 2013, any difference between:
    - the amount of assets, liabilities and minority interests recognised, and

[1] IFRS 10 uses the term 'Non-controlling Interest' but this has been changed for the purposes of the Code to 'Minority Interest'

- the previous carrying amount of the authority's involvement with the subsidiary.

17. However, the extent to which these steps in paragraphs 15 and 16 above are followed depends on practicability (as discussed in paragraph 5). Paragraph 9.1.2.67 of the Code says that if measuring a. subsidiary's assets, liabilities and minority interests is impracticable, an authority shall:

- apply the requirements of IFRS 3 as of a deemed acquisition date (the beginning of the earliest period for which application of IFRS 3 is practicable, which may be 2014/15)
- adjust retrospectively the 2013/14 comparatives, unless the earliest date for which application is practicable is 1 April 2014
- where the deemed acquisition date is earlier than 1 April 2013, recognise, as an adjustment to reserves at 1 April 2013, any difference between:
  - the amount of assets, liabilities and minority interests recognised, and
  - the previous carrying amounts of the authority's involvement with the subsidiary.

(If the earliest period for which application is practicable is 2014/15, the adjustment to reserves shall be recognised at 1 April 2014.)

18. One of the crucial tasks in accounting for a newly defined subsidiary will be to determine the deemed acquisition date. Applying paragraph 5, analysis would only need to go back as far as all of the following hold:

- information is available to allow the effects of retrospective application to be determined and measured reliably, without having to make unreasonable efforts to obtain that information
- there is no requirement in preparing figures to make assumptions about what management's intent was at the time
- it is possible when making significant estimates to separate out (without introducing subjective judgements) the information that provides evidence of circumstances that existed on the date that amounts are to be recognised/measured/disclosed <u>and</u> would have been available when the financial statements for that year were authorised for issue

19. The Code does suggest that the deemed date could be 1 April 2014, but does not set this as a default position. In determining how far back it would be reasonable to make restatements, both practicability and materiality should be considered. It will be more significant to set a deemed date in an earlier year where material amounts of goodwill might have arisen upon the acquisition of control or it is considered important to have an accurate breakdown of the subsidiary's reserves in the Group Balance Sheet.

20. The views of the authority's experts will be relevant in assessing practicability. For instance, valuers will have views about how far back they are able to go in giving retrospective valuations for property that meet their professional standards and the practicability requirements of paragraph 3.3.2.3 of the Code.

Standards to apply when accounting for the business combination of a new subsidiary

21. When IFRS 10 was issued, there was some debate as to whether retrospective adjustments were to be made applying the current versions of relevant standards or the provisions that were applicable at the time items would have been recognised

and measured. The Code makes it a requirement that the 2008 versions of IAS 27 Consolidated and Separate Financial Statements and IFRS 3 Business Combinations are used in establishing adjustments for all newly defined subsidiaries (paragraph 9.1.2.68).

No longer consolidating a subsidiary

22. Paragraph 9.1.2.69 of the Code sets out the steps to be taken for an entity that was consolidated in the Group Accounts prior to 2014/15 but does not meet the new definition of a subsidiary:

- measure the authority's interest in the entity at 1 April 2014 at the amount at which it would have been measured if the requirements of IFRS 10 (as adopted by the Code) had applied when the authority became involved with the entity (or lost control of it) (eg, the entity might have been an associate if it had not previously been accounted for as a subsidiary)
- adjust retrospectively 2013/14 comparative figures
- if the date that the authority was first involved in the entity without having control (because it did not obtain control per IFRS 10 or it lost it) is earlier than 1 April 2013, recognise, as an adjustment to reserves at 1 April 2013, any difference between:
  - the previous carrying amount of the assets, liabilities and non-controlling interests, and
  - the recognised amount of the authority's investment in the entity.

23. However, the extent to which these steps are followed depends on practicability (as discussed in paragraph 5). Paragraph 9.1.2.70 of the Code says that if measuring the interest in the entity is impracticable, an authority shall:

- apply the requirements of IFRS 10 at the beginning of the earliest period for which application of paragraph 9.1.2.69 is practicable, which may be 1 April 2014
- adjust retrospectively the 2013/14 comparatives, unless the beginning of the earliest period for which application of this paragraph is practicable is 1 April 2014
- where the date that the authority became involved with or lost control of the entity is earlier than 1 April 2013, the authority shall recognise, as an adjustment to reserves at 1 April 2013, any difference between:
  - the previous carrying amount of the assets, liabilities and non-controlling interests, and
  - the recognised amount of the authority's interest in the entity.

Switching from consolidation to equity accounting for joint ventures

24. Under the previous arrangements authorities were able to use either proportionate consolidation or the equity method for jointly controlled entities. Paragraph 9.1.2.43 of the Code now requires use of the equity method.

25. Where a switch needs to be made from proportionate consolidation to equity accounting, paragraphs C2 to C4 of IFRS 11 Joint Arrangements set out the steps to be taken:

- the authority's investment in the joint venture should be recognised at 1 April 2013
- the investment at 1 April 2013 is measured as the aggregate of the carrying amounts of assets and liabilities (including any goodwill) previously proportionately consolidated

- this balance is to be regarded as the deemed cost of the investment at initial recognition but shall be assessed for impairment under IAS 28 Investments in Associates and Joint Ventures – any impairment loss is recognised as an adjustment to group profit and loss reserves[2] at 1 April 2013
- if the deemed cost is negative, a liability shall only be recognised if the authority has legal or constructive obligations in relation to the negative net assets – otherwise an adjustment to group profit and loss reserves should be made at 1 April 2013

26. Paragraph C5 of IFRS 11 requires disclosure of a breakdown of the assets and liabilities that have been aggregated into the single line investment balance at 1 April 2013. Where negative net assets are not recognised, disclosure is required by paragraph C4 of the fact this is the case, along with the cumulative unrecognised share of losses as at 1 April 2013 and up to 1 April 2014.

Switching from equity accounting to asset/liability accounting for joint operations

27. The new definition of joint ventures (requiring rights to the net assets of the arrangement, rather than rights to assets and obligations for liabilities) might result in some jointly controlled entities that were previously included in the Group Accounts being redefined as joint operations. Joint operations are accounted for in the single entity accounts, recognising the authority's share of assets and of liabilities. Where a jointly controlled entity becomes a joint operation, the Group Accounts will need to be adjusted so that the arrangement is no longer accounted for using the equity method.

28. Paragraph 9.1.2.72 of the Code (supported by paragraphs C7 to C11 of IFRS 11) specifies the following steps for the adjustment:

    - at 1 April 2013, derecognise the investment that was previously accounted for using the equity method
    - recognise the share of each of the assets and liabilities in respect of the authority's interest (including any goodwill that previously formed part of the carrying amount of the investment)
    - disclose a reconciliation between the investment derecognised and the assets and liabilities recognised

29. In preparing the 1 April 2013 carrying amounts of assets and liabilities, paragraphs C8 and C9 of IFRS 11 require in the Group Accounts:

    - disaggregation of the assets and liabilities from the carrying amount of the investment on the basis of the information used in applying the equity method
    - application of the specified proportions in the contractual arrangements to the assets and liabilities

    If any difference arises between the previously recorded investment and the net amount of assets and liabilities, this should be offset against goodwill (or group profit and loss reserves once goodwill is exhausted) if a debit or added to group profit and loss reserves if a credit.

30. Where a joint operation has previously been accounted for as a jointly controlled entity, an authority will probably have accounted for the interest as a financial asset at fair value or at cost in its single entity statements (paragraph 9.1.2.60 of the

[2] IFRS 11 uses the term retained earnings

Code). This asset should be derecognised at 1 April 2013 and replaced by the relevant shares of assets and liabilities, with any difference being posted to the General Fund Balance as an adjustment in the Movement in Reserves Statement.

31. Adjustments made per paragraph 30 have the potential to affect the General Fund Balance. For instance, suppose an authority had used the concession to carry an investment in a joint venture in its single entity Balance Sheet at historical cost of £1m but the authority's share of the assets and liabilities held by the joint arrangement is now £3m. The accounting transition would result in a gain of £2m to be recognised in the single entity statements.

32. Where gains result from the recognition of capital balances there should be no movement in the Capital Financing Requirement, as the gains arise from a change in accounting policy rather than any new responsibility to finance capital expenditure. The accounting process should then include adjustments to neutralise capital related effects on the General Fund Balance, almost usually by applying donated assets principles to transfer gains recognised to the Capital Adjustment Account.

33. Any remaining effects on the General Fund Balance will relate to revenue transactions, perhaps relating to timing differences between movements in the authority's interest in the joint operation's assets and liabilities and the distributions it receives or the contributions it makes to its running costs. Care should be taken to ensure that it is appropriate to leave any gains/losses against the General Fund Balance – ie, that there is no statutory basis that would require the impact to be reversed out.

Disclosure notes

34. The only specific concession in relation to the Code's adoption of the requirements of IFRS 12 Disclosure of Interests in Other Entities is made in paragraph 9.1.4.32. This allows the new disclosures in relation to unconsolidated structured entities to be restricted to 2014/15 (ie, no comparatives required for 2013/14).