Manchester City Council
Report for Resolution

Report to: Audit Committee – 11 March 2019

Subject: Accounting Concepts and Policies, Critical Accounting Judgements and Key Sources of Estimation Uncertainty

Report of: The City Treasurer

Summary

This report explains the accounting concepts and policies, critical accounting judgements and key sources of estimation uncertainty that will be used in preparing the 2018/19 annual accounts.

Recommendations

Members are requested to approve the accounting concepts and policies that will be used in completing the 2018/19 annual accounts and note the critical accounting judgements made and key sources of estimation uncertainty.

Wards Affected: All

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Background documents (available for public inspection):

The following documents disclose important facts on which the report is based and have been relied upon in preparing the report. Copies of the background documents are available up to four years after the date of the meeting. If you would like a copy please contact one of the contact officers above.

None

1 Introduction

1.1 This report details the accounting policies that will be used in the preparation of the 2018/19 accounts. It also explains the requirement to include notes on critical accounting judgements and key sources of estimation uncertainty.

2. Accounting Policies

2.1 The Council's accounting policies are the specific principles, conventions, rules and practices that are applied in preparing and presenting the annual accounts. These accounting policies have to be disclosed as a note to the annual accounts.

2.2 The accounting policies to be used in the preparation of the 2018/19 annual accounts are attached at Appendix 1. There are two significant changes in these accounting policies following the adoption of IFRS9 (financial instruments) and IFRS15 (revenue from contracts with customers).

Financial Instruments IFRS9

2.3 The revised accounting standard relates to the treatment of financial assets that are classed as financial instruments. These include cash, debtors (both long and short term), investments and shareholdings. Excluded from the definition are debtors that relate to taxation (e.g. VAT, business rates and council tax) and shareholdings in companies that are consolidated within the Council's group accounts (e.g. Manchester Airports Holdings Ltd).

2.4 This accounting standard requires the Council to review its financial assets and map them against new categories. Based on the assets the Council currently holds there is no impact on the Council's bottom line. In making decisions on the classification of these assets the holding of investments for strategic reasons and not primarily to trade will be key. Assets will need to be reviewed and impaired (i.e. reduced in value) where there is a risk the loan will not be repaid. The new classifications and how this works in practice are set out in the paragraphs below.

2.5 In previous financial years, financial assets were classified as loans and receivables, available for sale or unquoted equity investments at cost less impairment.

2.6 Loans and receivables assets were initially shown at fair value and then shown at amortised cost (where the interest is spread evenly over the life of the loan). That meant that the value on the balance sheet was the principal outstanding on the loan plus accrued interest to 31 March and as per the loan agreement.

2.7 Available for sale assets were shown and measured at fair value (the value they would be exchanged between a willing buyer and seller). For quoted shareholdings fair value was the market value and for unquoted shareholdings an estimate of the value was made based on the Council's share of the entity's total reserves. Changes in values in these assets were held in an unusable reserve – the Available for Sale Reserve.

2.8 Where a quoted market price was not available for a shareholding and could not be obtained at a reasonable cost the asset was held at cost less any impairment.

2.9 Under IFRS9 there are three categories of financial assets – amortised cost, fair value through other comprehensive income (FVOCI) and fair value through other profit and loss (FVPL). All financial assets classed as financial instruments have to be mapped to the new categories from 1 April 2018.

2.10 Assets classed as amortised cost are investments and debtors where the amounts received relating to them are solely principal and interest and they are held to generate cash returns. Assets that were previously classed as loans and receivables including the majority of the Council's treasury management investments and loans to third parties will now be classed as amortised cost. This classification will result in no change to the accounting treatments.

2.11 Assets classed as FVOCI are assets where the amounts received are solely principal and interest but the assets are held to collect cash and sell the assets (e.g. property funds). The Council does not currently have any of these assets.

2.12 Assets classed as FVPL are assets where the amounts received are not principal and interest. The Council's equity investments would fall within this category as income received would be in the form of dividends.

2.13 Where these equity investments are not held to trade but are held for strategic reasons the Council can choose to designate these investments as FVOCI rather than FVPL. The Council has taken the option to designate those investments that are considered to be strategic.

2.14 Where assets are classed as FVOCI or FVPL their value is assessed at each year end. For FVOCI assets any change in value is charged to an unusable reserve – the Financial Instruments Revaluation Reserve.

2.15 Changes in value for FVPL assets are charged / credited to the income and expenditure each year end and charged to general reserves. This is a change from the current arrangements.

2.16 There is a statutory override when the purchase of shareholdings or long term debtors have been classed as capital expenditure which means that any change in value is reversed to an unusable reserve – the Capital Adjustment Account. Any such expenditure that was revenue would not be reversed and would remain against general reserves.

2.17 As at 1 April 2018 the Council has mapped the existing asset classifications to the revised classifications and transferred the existing Available for Sale reserve to the Financial Instrument Revaluation Reserve and other earmarked reserves. This will be shown in the Movement in Reserves Statement in the annual accounts.

2.18 Assets classed as amortised cost or FVOCI (unless designated as such) have to be reviewed at each year end for impairment or credit loss. This means that this will mainly effect the long term loans to third party organisation, treated as capital expenditure, made by the Council.

2.19 There is a three stage approach to impairments after the asset has been initially included on the balance sheet. At stage 1 if there has been no significant increase in credit risk since the loan was given the amount included as impairment is 12 months expected credit losses i.e. the likelihood of default by the borrower over the next 12 months. This impairment would result in the asset being reduced in value on the balance sheet with the loss charged to the income and expenditure account. It should be noted that this this loss is unlikely to be nil unless there is a local authority or central government guarantee such as that relating to the Housing Investment Fund where any loss up to 20% is guaranteed by government.

2.20 Stage 2 of the process occurs if there is a significant increase in credit risk since the asset was recognised. If this was the case the amount included as impairment would be the lifetime expected credit losses i.e. the estimated amount of default over the life of the asset. At this stage interest income would continue be included on the original value of the loan.

2.21 At Stage 3 the asset would become impaired if the debtor fails to meet its obligations i.e. failure to pay principal or interest due. Again lifetime expected credit losses would be charged as impairment but in this case interest would be include on the lower value of the loan i.e. the principal outstanding less impairment.

2.22 Any impairment on loans that were treated as capital expenditure would be reversed out of the income and expenditure account and charged to the Capital Adjustment Account.

2.23 Due to the statutory overrides introduced it is not expected that the introduction of this accounting standard will have a significant impact on the general usable reserves of the Council. The disclosures that accompany this standard will provide additional transparency particularly of any failure of debtors to meet their repayment obligations.

Revenue from contracts with customers IFRS15

2.24 This revised accounting standards considers when income from contracts should be included in the accounts. In order to be classed as a contract an agreement does not have to be a written contract – it has to be approved by all parties, have identifiable rights and payment terms, have commercial substance and be probable that income will be collected.

2.25 In order to ascertain when income should be included the performance obligations in a contract have to be identified, the transaction price has to be determined, the transaction price allocated to each performance obligation and the income recognised as each performance obligation is satisfied.

2.26 Income can be included over time or at a point in time. Income will be recognised over time when service recipients are receiving and consuming a service e.g. care home provision. Any other income is likely to be recognised at a point in time.

2.27 The major impact of this standard is likely to be in the private sector, for example when an organisation is selling goods with a maintenance contract included. The income for the sale of goods would be recognised immediately but dependant on the contract terms the income relating to maintenance could be recognised over the life of the contract or at the start of the contract.

2.28 It is not anticipated that this accounting standard will significantly change the current treatment of income in the Council's accounts.

3 Critical Accounting Judgements

3.1 In accordance with International Accounting Standards the notes to the accounts contain details of critical accounting judgements that have been made in completing the annual accounts. These are shown in Appendix 1. The judgements taken include which schools property, plant and equipment and Private Finance Initiative (PFI) related assets should be included on the Council's balance sheet, whether a lease should be classed as a finance or operating lease, whether a property should be classed as an operational property, an investment property or a heritage asset, classification of financial assets within financial instruments, treatment of transactions within the Better Care Fund and whether an organisation should be included within the Council's group accounts.

4 Key Sources of Estimation Uncertainty

4.1 In preparing the annual accounts there are areas where estimates are made. These include:

- useful lives and valuations of properties which are estimated by qualified valuers;
- valuations of investments;
- provision for business rate appeals based on claims received and previous experience of the outcome of appeals;
- provisions for known compensation claims which are estimated based on experience of similar claims;
- the amount of arrears that will not be collected which are estimated based on expectation of collection of different types of debt; and
- the liability for future pension payments which is estimated by qualified actuaries.

Details of these are shown in Appendix 1.

5 Recommendations

5.1 The recommendations appear at the front of this report.