AGENDA ITEM 11

TRANSPORT FOR LONDON

AUDIT COMMITTEE

SUBJECT: CHANGES IN LEGISLATION AND ACCOUNTING STANDARDS IMPACTING ON TfL

DATE: 16 DECEMBER 2009

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1 PURPOSE AND DECISION REQUIRED

1.1 To update the Audit Committee on the Group's critical accounting policies to be applied in deriving the form and content of TfL's Statement of Accounts for the year ending 31 March 2010.

1.2 This update reflects any changes to the Code of Practice on Local Authority Accounting published by CIPFA ("the SORP"), changes resulting for the adoption Companies Act 2006 and any other changes to UK accounting and reporting standards which may have an impact on TfL's Statement of Accounts for the year ending 31 March 2010.

2 BACKGROUND

2.1 TfL's Statement of Accounts are prepared in accordance with the provisions of the Audit Commission Act 1998 and the Accounts and Audit Regulations 2006 ("the Regulations"). The form and content followed in preparing the Statement are as prescribed in the Regulations and by the SORP. The accounting policies followed are also substantially as prescribed by the SORP.

2.2 The SORP is updated annually by the CIPFA/LASAAC Joint Committee, a standing committee of CIPFA and LASAAC (Local Authority (Scotland) Accounts Advisory Committee). In deriving the SORP, the Joint Committee follows the Accounting Standards Board's Code of Practice for bodies recognised for issuing SORPs.

2.3 This paper deals with the critical accounting policies as they relate to the accounts for the year ending 31 March 2010.

3 DEVELOPMENTS IN UK ACCOUNTING STANDARDS AND THE 2009 SORP

3.1 The updated SORP to be adopted in 2009 ("2009 SORP") will reflect the new UK Financial Reporting Standards and Urgent Issues Task Force issues (UITFs) issued prior to 30 September 2008. This new SORP is applicable to TfL's accounts for the year ending 31 March 2010. The 2009 SORP is currently an exposure draft and the finalised version will be available from 17 December 2009.

3.2 There are no major changes in the 2009 SORP that will impact TfL, except for new rules governing the accounting for PFI/PPP transactions which are discussed below.

Changes in accounting for PFI /PPP transactions

3.3 Under existing requirements applicable to accounting periods up to 31 March 2009, PFIs and PPPs have been accounted for under Financial Reporting Standard 5, Application Note F and HM Treasury Technical note No.1. A risks and rewards approach was applied to determine whether the Local Authority or the operator had an ownership interest in the property. Risks and rewards were assessed qualitatively and measured quantitatively in monetary terms using discounted cash flow techniques. PFI assets were concluded to be on-balance sheet for the Local Authority if the majority of the balance of risks and benefits rested with the Local Authority.

3.4 The draft 2009 SORP incorporates requirements for accounting for PFI schemes and similar arrangements that are consistent with the adaptation of IFRIC 12 *Service Concession Arrangements* contained in the Government's 2009/10 IFRS-based Financial Reporting Manual (i-FReM) and Whole of Government Accounts' requirements.

3.5 Both IFRIC 12 and the 2009 SORP follow an approach that seeks to establish which party controls the property by applying two key control tests:

- Whether the Local Authority controls the nature, pricing and to whom the services of a PFI arrangement are provided; and
- Whether the Local Authority controls, through beneficial ownership or otherwise, any significant residual interest in the property at the end of the concession.

3.6 If the two control tests are met, the arrangement falls within the scope of IFRIC 12 and will be accounted for on-balance sheet by the Local Authority.

3.7 The impact of the new controls approach compared with the previous risks and rewards approach is that, potentially, more PFI projects will be brought on the balance sheet for the public sector. This means that the infrastructure will be recognised within fixed assets on the balance sheet and depreciated over its useful life. A corresponding financial liability representing the obligation to make payments under the PFI will be recognised and an interest expense will be charged on it. Prior year numbers in income and expenditure and balance sheet will need to be adjusted, as the changes will be required to be applied retrospectively.

3.8 TfL has carried out a study with Ernst & Young on a sample of five different PFI projects. The aim of the study was to define the scope of the changes required by the 2009 SORP and provide a foundation for setting group wide policy.

3.9 The Ernst & Young work is almost complete and KPMG have reviewed the accounting papers supporting the proposed treatment of the PFI projects under IFRIC 12. KPMG will review the accounting models supporting the IFRIC 12 adjustments and the required accounting entries before the end of January.

3.10 Although the Tube Lines PPP contract and the DLR PFI contracts are currently on balance sheet, other PFI contracts are not. The impact of this change in accounting policy is that the following PFI contracts will come on balance sheet:

(a) Power (within London Underground);

(b) Connect (within London Underground);

(c) A13 Thames Gateway DBFO contract (within Surface Transport); and

(d) British Transport Police PFI contract for a new headquarters building (within London Underground).

The finance lease creditor at 31 March 2010 arising from these four PFI contracts is estimated in the range of £550 to £600 million. TfL's understanding of its SR07 funding settlement with Government is that this additional finance lease creditor to be recognised on the balance sheet will not form part of the Prudential Borrowing limits agreed with the Government on the basis that they are the unavoidable effect of the accounting changes rather than constituting new borrowings.

4 INTERNATIONAL FINANCIAL REPORTING STANDARDS

4.1 The transition from UK Accounting Standards to International Financial Reporting Standards (IFRS) represents a very significant change to UK public sector financial reporting.

4.2 With effect from the year ending 31 March 2011, Local Authorities will be required to prepare their own accounts following IFRS. CIPFA has issued a draft "Code" for Local Authorities to replace the SORP, which will apply from 1 April 2010.

4.3 There will be significant changes to the format and content of the Financial Statements and, in the year of conversion, Transition Statements, reconciling one methodology to the other, are required. Detailed work will be undertaken to identify those changes and compute the first adoption adjustments required to effect the transition.

4.4 There will be an impact on General Fund and reserves, however the quantum is not yet known. Likewise asset and liability values will be subject to change.

4.5 An IFRS project has been established to coordinate the transition across the whole of TfL. The governance of the project is planned to operate as follows:

(a) The Audit Committee will receive quarterly progress updates from the project. In addition, the Audit Committee will be requested to approve new IFRS accounting policies, and specific treatments such as PFI and matters of accounting judgements with significant effect;

(b) An IFRS Project Steering Committee will oversee the delivery of the objectives of the project comprising modal Heads of Finance plus other key internal stakeholders;

(c) An IFRS Project Technical Committee will advise the project work-streams on technical matters and will recommend new IFRS accounting policies intended to be generic policies operating across all modes of the organisation. The Technical Committee will be made up of technical accounting specialists from Group Financial Accounting, the modes, internal audit and KPMG;

(d) Project delivery teams will be set up to report to the project progress in their modal areas, although it is intended that these teams will be multi – disciplinary and work cross-functionally to ensure consistent approach and delivery; and

(e) A project manager has been appointed in the Group Financial Accounting Team to coordinate the project activities

4.6 The project delivery teams will be responsible for work-streams identified at the outset that have been identified as key areas of potential change. The teams will be supported by bespoke IFRS training and guidance from the Technical Committee. The team members will be business finance staff identified by their managers as "IFRS Champions" for their operational areas.

4.7 The objectives of the project are to achieve the fundamental deliverables of:

(a) Restated opening balance sheet at transition date (1 April 2009);

(b) IFRS compliant generic accounting policies;

(c) Restated 2009/10 comparative IFRS financial statements and disclosure notes;

(d) IFRS 2010/11 budget (over-laying IFRS adjustments to the 2010/11 budget process output);

(e) New procedures and policies embedded into working practices to ensure IFRS compliant reporting can be delivered on an ongoing basis in all TfL entities;

(f) Systems changes implemented, including new SAP codes, account mapping changes, and collation and consolidation of non-trial balance disclosure data ;

(g) Whole of Government Accounts (WGA) submission of 2009/10 financial statements with IFRS adjustments overlaid;

(h) Full IFRS financial statements and disclosure notes 2010/11; and

(i) Effective communication to all key stakeholders, including modal finance teams, HR, Legal, Group IM, Group Marketing and Communications, Internal and External Audit.

4.8 The format and presentation of the financial statements will be different under IFRS, with significant additional disclosure required. Other areas where there are differences include property, plant and equipment; leases; employee benefits; and investment property. PFIs will have already been brought on to the balance sheet in TfL for the 2009/10 accounts, as stated above.

4.9 It is anticipated that all subsidiary companies will also report under IFRS with effect from the year ending 31 March 2011 to avoid significant reconciliation and restatement work in the preparation of the Group accounts. The IFRS Project Steering Committee and the Audit Committee will be asked to confirm this approach at an early stage.

4.10 Under strict IFRS as applicable to UK limited companies, borrowing costs must be capitalised (IAS 23). A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale. Subsidiary companies will therefore be required to capitalise interest on long-term projects funded by Prudential Borrowing. TfL currently expenses borrowing costs, however, under the Code it is likely that the option to capitalise (which will be required in the subsidiaries) will also be available to TfL. A decision on this will be required following issue of the finalised Code.

Impact for year ending 31 March 2010

4.11 HM Treasury set the revised timetable for the transition to IFRS in order to achieve IFRS-compliant financial statements for Central Government for the year to 31 March 2010, although as noted above Local Authorities will not move to IFRS until 2010/11. The phased approach to implementation will result in Local Authorities being required to submit IFRS adjusted 2009/10 results for the Whole of Government Accounts (WGA) process in advance of their first IFRS accounts being produced for the year ending 31 March 2011.

4.12 No guidance has yet been issued to Local Authorities on the extent of the adjustments required for the 2009/10 WGA return.

5 COMPANIES ACT 2006

5.1 The provisions of the Companies Act 2006 were phased into operation, with the final elements implemented in 2009. These provisions affect the statutory accounts of the subsidiary companies for the year ending 31 March 2010, although they are not relevant to the financial statements of TfL. The main areas of change are:

(a) Disclosure separately of all services provided by the auditors (audit fee and all other services), and the requirement to report one of four distinct opinions;

(b) Governance and disclosure requirements; and

(c) Enhanced Business Review (if an Operating and Financial Review “OFR” report as prescribed by the Accounting Standards Board is prepared then s417 of the Companies Act 2006 is deemed to be met).

5.2 The Enhanced Business Review requires a comprehensive and balanced (fair) review of the company’s business and a description of the principal risks and uncertainties facing the company.

6 RECOMMENDATION

6.1 The Audit Committee is asked to NOTE the contents of this report.

7 CONTACT

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